

Enabling Recovery and Macro Stability in LDCs

A Study for the Least Developed Countries Report 2010

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1. Summary

The governments of the least developed countries face many obstacles to fostering stable and sustainable growth that is substantially poverty reducing. This paper treats two of the most important, resources for investment and policy space to implement those policies which stability and growth require. The conditionalities set on funds by donors and lenders governments for decades have had the effect of disempowering policy makers in developing countries. The conditionalities have decommissioned the key instruments of macro management by setting limits on fiscal deficits, maximum inflation targets, and minimum foreign exchange guidelines. This is “aid dependency” in its most debilitating manifestation. Abandoning these conditionalities and allowing governments to manage their economies would empower policy, make assistance more effective and, as a result, stimulate growth.

The presentation is divided as follows. Section 2 considers the dramatic policy shift that occurred in the wake of the global downturn. Section 3 reviews the impact of the global financial crisis on the Least Developed Countries, estimating “high” and “low” growth scenarios for the coming years. It concludes that if the growth of the developed OECD countries recovers to two percent per annum, the cross-country average for the LDCs could be as low as three percent, barely sufficient to prevent per capital income from falling.

The contribution of development assistance is treated in Section 4. A review of the statistical evidence on ODA flows indicates that levels of assistance to LDCs are generally modest, and increases are required to achieve a recovery from the global downturn. For all developing countries and especially the least developed, discussion should move beyond the arid debate over the effectiveness of assistance to serious consideration of how it can be effectively used for economic recovery. Essential to this would be the creation of a mechanism for flexible use of development assistance, an “Aid Fund”.

Section 5 considers domestic policies in LDCs that could be used to facilitate that recovery. Three types of constraints limit the ability of governments to implement macroeconomic recovery programmes, external agreements that restrict policy instruments, macro performance indicators that may conflict with economic expansion, and donor and lender conditionalities on policy space. This section treats

the first two in detail. Section 6 analyses policies for increasing long term growth in least developed countries.

Designed and implemented by governments with support from donors and lenders, a macroeconomic recovery programme is feasible for most least developed countries. It would prevent increases in poverty and, with sufficient external support, could contribute to meeting the Millennium Development Goals: 1) by managing stability with growth in response to the global financial crisis through countercyclical fiscal policy with exchange rate management; 2) by raising the sustainable growth rate through use of public investment and low interest rates to foster private investments; and 3) by designing both the medium and long term macro policies to generate pro-poor growth. Achieving this purpose will require overcoming structural bottlenecks, transforming weak domestic financial systems, and fostering administrative capacity in the public and private sectors.

2. Appropriate Recovery Policy for the LDCs

The financial crisis that began in the United States in 2008 had a global impact. The effects differ among countries, especially with regard to policies implemented before it began. An automatic recovery return to robust global growth is extremely unlikely. Before the crisis most Least Developed Countries had orthodox fiscal and monetary policies in place.¹ Those policies are notably inappropriate to counter the effects of the crisis, as well as inappropriate at the time they were implemented. The changed circumstances of the new decade require a change in policy regime, from orthodox policy neutrality to countercyclical intervention.

In August 2009 African finance ministers met in Freetown and proposed an alternative to the prevailing orthodoxy, the Freetown Declaration. The ministers and their representatives, including those from almost all the African least developed countries of the region, issued a declaration unusual for its clarity, forcefulness and its break with prevailing policy. Unlike previous declarations that had pledged the

¹ At the height of the global expansions, UNCTAD was prescient in its anticipation of a possible downturn: “The LDCs remain very vulnerable to a growth slow-down...” (UNCTAD 2008, Highlights), www.unctad.org.

governments to orthodox policies of macro stability and institutional reform,² the Freetown Declaration issued a bold declaration relevant for all the LDCs,

We, the African Governors to the BWIs and AfDB, commit to...
Implement fiscal stimulus measures where appropriate to weather the impact of the global economic downturn;
Expand high-growth yielding public investments...to restore and raise our countries growth and employment potential as well as crowd-in private investment;
Implement monetary policies that support the short-term fiscal stimulus measures...
Remain prepared to exit from the countercyclical fiscal stimulus policies as soon as the macroeconomic conditions permit. (CAG 2009)

These commitments, if implemented, would represent a break with the standard IMF macroeconomic framework that stresses minimising fiscal deficits and a tight monetary stance to achieve low inflation, usually single digit. The commitment to a fiscal stimulus would imply a lower fiscal surplus for a few countries and for most it would mean a larger deficit. More fundamentally, the commitment to a stimulus implies using the deficit as part of an active fiscal policy rather than as a problem to be reduced.

The commitment to increase public investment has three implications that are potentially inconsistent with orthodox macro policy. First, it asserts the public sector as an active driver of growth rather than merely establishing the framework for private sector driven growth. Second, the IMF and World Bank view that public borrowing “crowds out” private investment is explicitly reversed: the Declaration asserts that public investment, which would by necessity be financed through borrowing, can “crowd-in” private investment.³ Third, it provides an implicit strategy for an active fiscal policy: countercyclical intervention will be used to stabilize output near potential, and public investment will foster higher growth rates through increased productive capacity.

A further break with Washington Consensus macro policy is made by the commitment to use monetary policy to support the active fiscal policy. While policy

² For example, the declaration of October 2007 referred to “wide array of far-reaching reforms to achieve macroeconomic stability”. The full text of the statement is found at: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21520315~pagePK:34370~piPK:34424~theSitePK:4607,00.html>

³ A case for public investment as a driver of poverty reducing growth is found in Roy and Weeks (2004). The orthodox view that public investment crowds out private is stated without nuance at <http://blogs.worldbank.org/african/a-fiscal-stimulus-for-africa>.

consistency requires that fiscal and monetary measures be coordinated, an accommodating monetary policy contradicts one of the basic tenets of most IMF programs, inflation targeting, as well as associated limits on money growth. Even more fundamental, committing monetary policy to support fiscal policy renders it derivative from fiscal policy, a return to so-called Keynesian macro management. Finally, the commitments explicitly emphasize the fiscal stimulus as countercyclical and short term by specifying the need to exit from it as economies recover.

After stating the recovery program, the Freetown Declaration presents a list of “requests” for the multilateral development agencies of which they are governors,

To this end [the fiscal stimulus], African IMF/WBG Governors urge the International Monetary Fund to

- Support our policy frameworks [and give] us the needed policy space...to leverage [external] resources...
- Facilitate expeditious access to the newly created financing instruments;
- Mobilize additional resources to allow an increase in concessionary lending while ascertaining that these new instruments are fully funded;
- Promptly activate the precautionary component of the SCF [Special Credit Facility].

We ask the World Bank Group to introduce more flexible and adaptable budget support instrument that is capable of responding quickly to crisis.

The second, third and fourth requests of the IMF are derivative from the first, allowing governments the flexibility, “policy space”, to design and implement their programs. The request of the IMF for “expeditious access” and of the World Bank for “more flexible and adaptable budget support” reflects a general view among the officials at the Caucus of tardiness by the Fund and the Bank in their response to the impact of the global crisis on African countries.

The Freetown Declaration abandoned the macro policy framework common to most countries prior to the international financial crisis of 2008. The macroeconomics of this orthodox framework combined a cautious monetary stance and a neutral fiscal policy, in the context of market deregulation. This policy approach, based on a “price constrained framework”, has as its prerequisite that the world economy operates near its potential.⁴ From mid-2008 it was clear that aggregate demand was insufficient to permit the world economy to achieve its

⁴ An early use of this terminology is in Liejonhufvud (1968, Section 2). The theoretical and policy difference between “price constrained” and “quantity constrained” economies is discussed in Weeks (1989). The recently revised edition of that book can be found at <http://jweeks.org>.

potential. In response governments of the major industrial countries introduced “stimulus packages” designed to replace the fall in private demand with public expenditure.

In this demand constrained world economy, governments of LDCs have two broad policy options. They can pursue a “business-as-usual, hope-for-the-best” option in which they continue with the policy framework designed for a robust world economy and await international recovery. This would follow advice to place primary emphasis in macro policy on “stability”, which in IMF terminology means preventing inflation, reaching targets for fiscal deficits, and maintaining a free-floating exchange rate.⁵ It does not mean stabilizing output by policy intervention.

However, the crisis may have brought a degree of change in IMF policy advice. A January 2009 IMF report on the world economy called for a “firm commitment” to a “timely implementation of fiscal stimulus across a broad range of advanced and emerging economies”. In line with this commitment, a May 2009 official press release reported that the IMF recommended a fiscal stimulus for an LDC, Mozambique.⁶ In its survey of the impact of the financial crisis, the World Bank also recommended that governments “assess their ability to undertake countercyclical policies”.⁷ The African Development Bank as well recommended

⁵ A clear statement of this approach is found in an IMF report on the global financial crisis, Countries should focus on macroeconomic stability. In some countries with falling inflation there may be scope for monetary easing; others, however, still experience continued or renewed price pressures. Those with flexible exchange rates should allow them to move, so that they function as shock absorbers. (IMF 2009a, viii)

⁶ The complete IMF statement on fiscal policy reads as follows, In current circumstances, the timely implementation of fiscal stimulus across a broad range of advanced and emerging economies must provide a key support to world growth. Given that the current projections are predicated on strong and coordinated policy actions, any delays will likely worsen growth prospects. Countries that have policy room should make a firm commitment to do more if the situation deteriorates further. Fiscal stimulus packages should rely primarily on temporary measures and be formulated within medium-term fiscal frameworks that ensure that the envisaged build up in fiscal deficits can be reversed as economies recover and that fiscal sustainability can be attained in the face of demographic pressure. (IMF 2009c, 1)

A press release titled “IMF Mission Calls for Fiscal Stimulus in Mozambique” states, “In the short term, given Mozambique’s low level of public debt, the [IMF] mission sees scope to at least partly offset the impact of the global economic crisis on Mozambique with somewhat more expansionary fiscal and monetary policies.” (IMF 2009d). The IMF approved higher deficit limits for El Salvador and Ethiopia (Bretton Woods Project 2009, 9)

⁷ “The challenge for policymakers in this environment is to assess their ability to undertake countercyclical policies given the resources available to them as well as their institutional and administrative capacity to rapidly expand and adapt existing programs.” (WB 2009, 10)

countercyclical fiscal intervention.⁸ Without explicitly mentioning countercyclical measures, in 2009 the IMF recommended for Sierra Leone that the country's fiscal deficit be allowed to increase to respond to the impact of the financial crisis on import prices.⁹ However, among professionals in the Bretton Woods institutions there remains a commitment to the pre-crisis orthodoxy.¹⁰

3. Impact of the Global Crisis on LDCs

Initial hopes that the global crisis would have little affect on countries with undeveloped financial sectors ended when financial collapses in developed countries led to a general downturn that affected world commodity trade. The developed country recession reduced international capital flows, though the short term impact of this on growth would not be great in LDCs. Of more concern for the least developed countries would be the effect of the downturn on development assistance, which is treated in the next section.

The least developed countries comprise a diverse group with substantially different economic characteristics. In Table 1 and Figure 1 the forty-six LDCs for which there are data are divided into five groups based on structural characteristics, with "small states" defined as those with populations of less than one million. The average growth rate for the African LDCs and small states was much the same for the two decades, with that for the conflict-affected countries slightly lower and much more variable. The highest growth rates were by the five petroleum exporting countries, with the "other" group much lower, though robust. The table indicates that for most of the forty-five countries average growth performance was weak, below four percent per annum.

⁸ The African Development Bank's 2009 report calls on donors and lenders to "[Focus] on results, rather than prescribing rigid policies and actions, allowing countries space to respond according to their particular needs and circumstances". More specific, it recommends that donors and governments "[i]ncrease flexibility in macroeconomic frameworks to allow more scope to balance macroeconomic stability and the need to stimulate domestic demand". (ADB 2009, 2)

⁹ "[IMF] Staff is proposing that the primary fiscal deficit be revised upward by 0.4 percentage points of GDP to accommodate the unanticipated budget impact of the rise in world oil prices." (IMF 2009b, 5).

¹⁰ In his personal blog in early 2010 the World Bank chief economist for Africa, Shanta Devarajan, argued against a fiscal stimulus "for Africa" on the grounds that increasing a fiscal deficit would result in inflation or a reduction in private investment ("crowding out") or both. <http://blogs.worldbank.org/africacan/a-fiscal-stimulus-for-africa>.

A characteristic shared by all LDCs is the smallness of the domestic market, even for the most populous countries, Bangladesh, Democratic Republic of Congo and Myanmar. This suggests that the growth performances are strongly influenced by conditions in international markets, and it is on this hypothesis that scenarios of medium term growth rates can be calculated. Figure 2 shows the difference between the growth rates of the African LDCs, small states and “others”, and the average rate for the developed OECD countries. For all three groups the gap between the growth rates increases substantially in the 2000s compared to the 1990s. This difference is less systematic for the conflict affected countries whose growth was strongly influenced by internal factors. The differences also showed a weaker pattern for the petroleum exporters whose growth appears to have been more directly influenced by the price of oil than the growth of the world economy, though the two were related.

On the basis of the hypothesised relationship between OECD and LDC growth, projections are made for the latter and presented in Table 2. Both scenarios, “low” and “high” (last two columns), assume an average growth rate for OECD countries of two percent per annual, and the projections refer to a time period over which that rate prevails. If the OECD recovery is sluggish, as many commentators anticipate, the assumption of a two percent rate may be appropriate for the first half of this decade.¹¹ Using this rate and dividing the LDCs into groups by major export product, two projections for each country are calculated as follows.¹²

1. For the agricultural exporters (beverage, annual agriculture and “other” agriculture) growth scenarios are the sum of the difference with the OECD for 2000-2003 and 2004-2008 plus two percentage points.
2. For the mineral exporting countries, the growth scenarios are the same as above, with a regression-based adjustment factor of 1.6 percentage points subtracted from the “low” scenario.
3. The rates for the conflict countries in each export category are calculated as for the mineral exporters, with an adjustment of minus 1.3 percentage points for the “low” scenario.
4. The regression exercise indicates a positive adjustment for energy exporters equal to 3.8 percentage points, added to the “high” scenario.

¹¹ See “Recovery arriving quicker than expected but activity will remain weak, says OECD”, at www.oecd.org/document/3/.

¹² See notes to Table 2 for more detail.

5. For the small states a regression-based adjustment of 1.5 percentage points is added to the “high” scenario.

Across all countries, these calculations yield a “low” scenario of 3.8 percent and a “high” of 7.9 percent. If one excludes the energy exporters, whose growth rates were extremely high during 2004-2008, the averages fall to 2.6 and 6.3. Before inspecting the disaggregated results, it is useful to consider the value of projections with such a wide range of outcome, and whether it is possible to assign likelihoods within the range. The limits of the range for each country can be considered the “worst” and “best” outcomes. For example, if the economy of Burundi were to respond to developed country growth as it did in the early 2000s, and were there a recurrence of civil strife, its growth rate is likely to be negative. However, if the economy shows the more robust performance of the second half of the 2000s and conflict is avoided, the growth rate could be almost five percentage points higher.

If the low scenarios prevail across all countries, as many as twenty of the LDCs might experience a fall in per capita income. If one excludes the energy exporters, almost all of which would maintain strong growth under the low scenario, over half of LDCs might suffer per capita decline. If, however, the high scenario were realised, it is likely that in only three countries might per capita income fall (Eritrea, Guinea-Bissau and Haiti).

Historical experience suggests that for most countries an outcome close to the low scenario is more likely than one close to the high scenario. The high scenario requires a growth difference with OECD countries of almost plus five percentage points. Figure 3 shows that a growth difference of this amount or more occurred in twenty-seven percent of the over eight hundred observations, 1990-2008. This high growth share was slightly less than the percent of growth differences that was negative. The mean and the median across all years and countries were 2.3 percentage points, close to the difference used by the low scenario. The information in Figure 3 suggests that outcomes close to the low scenario are more likely than ones near the high scenario. This pessimistic conclusion might be moderated for the ten conflict countries, whose projected growth rates would be 1.3 percentage points higher in the low scenario were civil peace to be maintained.

It is quite possible that for the foreseeable future that many LDCs may suffer from stagnant per capita income with no reduction or even increases in poverty head count rates. This would be the direct result of slow growth of the OECD countries.

Therefore, it is relevant for the governments of most LDCs to consider, design and implement recovery programmes that provide the basis for sustainable growth. Before considering the design of such programmes, the next section reviews the flows of development assistance to LDCs.

Table 1: GDP Growth of Least Developed Countries by Group, 1990-2008

	<u>African (17)</u>	<u>Small states (8)</u>	<u>Oil Exp (5)</u>	<u>Conflict (11)</u>	<u>Other (5)</u>	<u>All 46</u>
1990	1.8	5.2	-1.7	-5.0	4.9	.6
1991	2.6	-1.0	3.1	-1.7	3.2	1.4
1992	.2	4.9	5.3	-7.6	1.8	-.1
1993	2.8	1.3	-5.1	-3.0	3.4	.3
1994	2.0	3.9	4.4	-3.7	3.0	1.1
1995	5.4	.8	8.7	3.9	4.2	4.7
1996	5.0	3.4	10.9	6.5	5.6	5.9
1997	4.9	4.3	20.7	12.4	5.2	8.5
1998	4.3	5.4	9.3	1.9	4.6	4.5
1999	4.7	2.8	10.0	4.0	6.5	5.0
2000	2.9	1.1	5.7	5.1	6.7	3.8
2001	4.7	-1.2	17.5	6.0	5.7	5.6
2002	1.9	3.4	10.3	5.4	6.2	4.3
2003	4.9	3.7	8.4	-.2	6.9	4.0
2004	4.5	4.9	18.4	6.0	6.0	6.6
2005	4.8	3.3	10.0	6.9	7.0	5.8
2006	6.2	5.1	6.9	6.6	7.2	6.2
2007	4.9	5.3	11.1	7.0	8.0	6.4
2008	<u>5.9</u>	<u>5.9</u>	<u>7.6</u>	<u>6.1</u>	<u>7.2</u>	<u>6.2</u>
Aver.	3.9	3.3	8.5	3.0	5.4	4.3

Source: World Development Indicators 2010.

Notes:

Forty-five countries; no GDP growth data for Samoa, Somalia and Tuvalu.

African (non-conflict, non-oil exporting): Benin, Burkina Faso, Central African Republic, Gambia, Guinea, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Niger, Senegal, Tanzania, Togo, Uganda and Zambia.

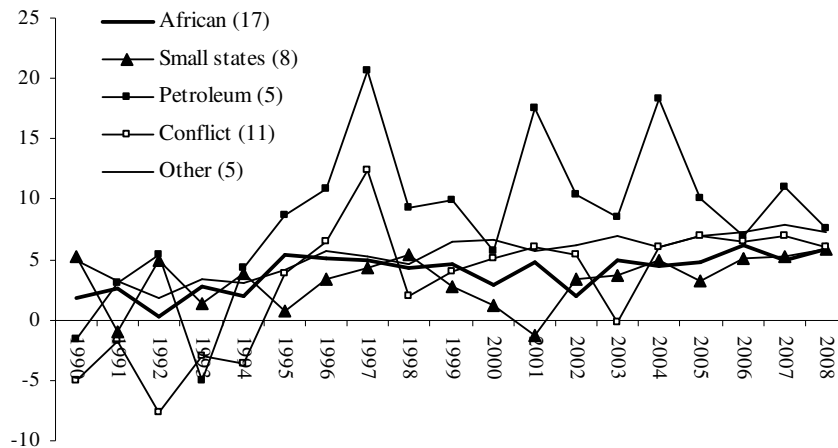
Small states (population less than one million): Comoros, Sao Tome & Principe, Djibouti, Kiribati, Solomon Islands, Timor-Leste, Vanuatu, and Maldives.

Petroleum: Angola, Chad, Equatorial Guinea, Sudan and Yemen.

Conflict: Burundi, Congo DR, Eritrea, Ethiopia, Guinea-Bissau, Liberia, Rwanda, Sierra Leone, Cambodia, Afghanistan, and Nepal (excludes Somalia, no data).

Other: Bangladesh, Bhutan, Haiti, Laos and Myanmar.

Figure 1: Least Developed Countries, GDP growth by group, 1990-2008



Source: World Development Indicators 2010.

Notes:

African (non-conflict, non-oil exporting): Benin, Burkina Faso, Central African Republic, Gambia, Guinea, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Niger, Senegal, Tanzania, Togo, Uganda and Zambia.

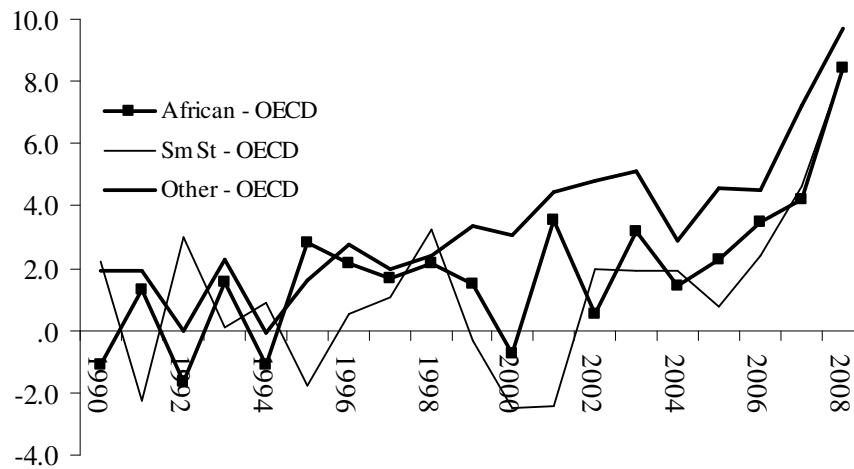
Small states (populations less than one million): Comoros, Sao Tome & Principe, Djibouti, Kiribati, Solomon Islands, Timor-Leste, Vanuatu, and Maldives.

Petroleum: Angola, Chad, Equatorial Guinea, Sudan and Yemen.

Conflict: Burundi, Congo DR, Eritrea, Ethiopia, Guinea-Bissau, Liberia, Rwanda, Sierra Leone, Cambodia, Afghanistan, and Nepal (excludes Somalia, no data).

Other: Bangladesh, Bhutan, Haiti, Laos and Myanmar.

Figure 2 Least Developed Countries, GDP growth minus OECD Growth, by group, 1990-2008



Source: World Development Indicators 2010 and www.OECD.org.

Table 2: Actual and projected growth rates for 46 Least Developed Countries

Countries	Exports/ GDP	Actual growth		Actual - OECD		Projection for OECD = 2%	
		2005-7	2000-3	2004-8	2000-3	2004-8	Low
All countries	30.8	4.4	6.4	2.4	5.0	3.8	7.9
Excluding Energy	26.7	3.2	5.3	1.3	4.1	2.6	6.3
Beverages (7)	15.9	4.1	6.9	2.2	5.3	3.7	7.7
Burundi	11.1	1.1	3.8	-9	2.5	-2	4.5
Ethiopia	13.9	3.4	11.7	1.4	10.4	1.9	12.4
Madagascar	29.1	2.0	5.6	.0	4.3	2.0	6.3
Rwanda	9.9	7.0	7.8	5.0	6.5	5.7	8.5
Sao Tome & P	Na	8.5	6.1	6.9	4.9	8.9	8.4
Uganda	15.4	5.9	8.4	3.9	7.1	5.9	9.1
Timor-Leste	na	.9	5.1	-1.1	3.8	.9	7.3
Annual agric (5)	26.4	4.4	4.3	2.4	3.0	4.4	5.0
Benin	13.5	4.8	3.9	2.8	2.6	4.8	4.6
Burkina Faso	10.8	5.3	4.9	3.3	3.6	5.3	5.6
Gambia	37.7	3.7	6.2	1.7	4.9	3.7	6.9
Mali	28.4	6.7	4.3	4.7	3.0	6.7	5.0
Togo	41.5	1.5	2.2	-.5	.9	1.5	2.9
Other agric (7)	22.2	1.4	4.6	-.6	4.4	.8	6.4
Afghanistan	23.1	nd	12.2	nd	10.6	nd	12.6
Eritrea	6.2	.5	1.3	-1.5	.0	-.8	2.0
Guinea-Bissau	26.0	-1.6	1.7	-3.6	.4	-2.9	2.4
Liberia	33.3	.3	6.4	-1.8	5.2	-1.1	7.2
Malawi	20.7	-.4	6.9	-2.4	5.7	-.4	7.7
Senegal	26.0	3.8	4.2	1.8	2.9	3.8	4.9
Tanzania	21.3	6.1	7.1	4.1	5.8	6.1	7.8
Minerals (7)	28.9	3.8	5.2	1.8	3.9	2.0	5.9
CAR	13.8	-1.4	2.9	-3.4	1.6	-2.9	3.6
Congo DR	28.9	.1	6.5	-1.9	5.2	-2.7	7.2
Guinea	33.0	3.0	3.6	1.0	2.3	1.5	4.3
Mauritania	49.4	2.9	6.1	.9	4.1	1.4	6.1
Niger	15.4	3.3	5.0	1.3	3.8	1.8	5.8
S Leone	23.3	14.7	6.8	12.7	5.5	11.9	7.5
Zambia	38.5	4.2	5.8	2.2	4.5	2.7	6.5
Energy (8)	45.3	9.6	10.6	7.6	9.0	9.3	14.8
Angola	75.7	6.0	17.1	4.0	15.8	4.7	21.6
Bhutan	44.3	8.1	9.6	6.1	5.7	8.1	11.5
Chad	55.3	8.5	8.3	6.5	7.0	7.2	12.8
Eq Guinea	85.4	27.2	16.3	25.2	15.1	27.2	20.9
Mozambique	36.8	12.7	7.7	10.7	6.4	12.7	12.2
Myanmar	9.0	3.3	13.3	1.3	12.0	3.3	17.8
Sudan	18.3	6.8	8.2	4.8	7.0	6.8	12.8
Yemen	38.0	4.0	4.0	2.0	2.7	4.0	8.5

Countries	Exports/ GDP	Actual	growth	Actual - OECD		Projection OECD	for = 2%
Manuf (6)	32.2	4.3	5.6	2.3	4.3	2.3	4.3
Lesotho	51.3	3.3	4.5	1.3	3.2	3.3	5.2
Haiti*	13.0	-.1	1.1	-2.1	-.2	-.1	1.8
Cambodia	66.0	8.0	10.0	6.0	8.7	6.7	10.7
Bangladesh	18.4	5.2	6.3	3.2	5.0	5.2	7.0
Laos	30.5	5.9	7.4	3.9	6.1	5.9	8.1
Nepal	13.7	3.8	4.0	1.8	2.8	2.5	4.8
Other Islands (6)	39.6	1.5	4.7	-.5	3.4	-0.5	3.4
Comoros	12.1	2.7	1.3	.7	.1	2.7	3.6
Djibouti	na	2.1	3.8	.1	2.6	2.1	6.1
Kiribati	14.0	1.6	1.7	-.4	.4	1.6	3.9
Maldives	89.0	8.1	7.2	6.1	5.9	8.1	9.4
Solomon Is	37.8	-4.6	7.3	-6.6	6.1	-4.6	9.6
Vanuatu	44.8	-1.0	6.6	-3.0	5.3	-1.0	8.8

Sources:

Growth rates: for LDCs, *World Development Indicators 2010*, with OECD growth from the OECD website (OECD.org).

Notes:

No GDP statistics for Samoa, Somalia and Tuvalu. Djibouti included in 'other islands' because almost all its exports are re-exports, making it inappropriate for the other categories.

*For Haiti it is assumed that external assistance is sufficient to compensate for the fall in GDP due to the natural disaster in 2010.

Country groups are determined by the principle export during 2004-2008, with the exception of Laos which is included in the manufacturing category (manufactures were about twenty percent of exports).

"Annual agric" is annual agricultural crops (in most cases cotton).

"Other agric" is other agriculture, for example tobacco and cashew.

Actual growth rates are the simple numerical average of annual rates.

[Actual - OECD] are the actual rates minus the OECD rate for the same time period.

Country growth rates for the "high" projection are the actual difference in the LDC and OECD growth rate for each country during 2004-2008 plus the two percentage points at which the OECD countries are assumed to grow. For some countries the following additions are made for the "high" projection:

1. for all small countries (population less than one million) 1.5 percentage points; and
2. for all energy exporters, 3.8 percentage points.

In the "low" projections, the actual difference in the LDC and OECD growth rate for each country during 2000-2003 plus the two percentage points is used, without the additions listed above, and with the following reductions:

1. for all conflict countries 1.3 percentage points; and
2. for all mineral exporters 1.6 percentage points.

The percentage point adjustments are taken from a cross-country time series regression of each LDC country growth rate for each year with the arguments being OECD growth, and binaries for country groups. Agricultural exporters were the excluded category. The time period was 1990-2008. The overall relationship is significant at a probably of less than .000. The results were:

$$\begin{aligned} \text{Ln[LDC}_i - \text{OECD}]_t = & .018 + .015[\text{small}] - .013 [\text{Conflict}] - .016([\text{Mineral}] + .038[\text{Energy}] \\ & (.00) \quad (.09) \quad (.06) \quad (.08) \quad (.00) \\ & + .006[\text{manufactures}] \\ & (\text{nsgn}) \end{aligned}$$

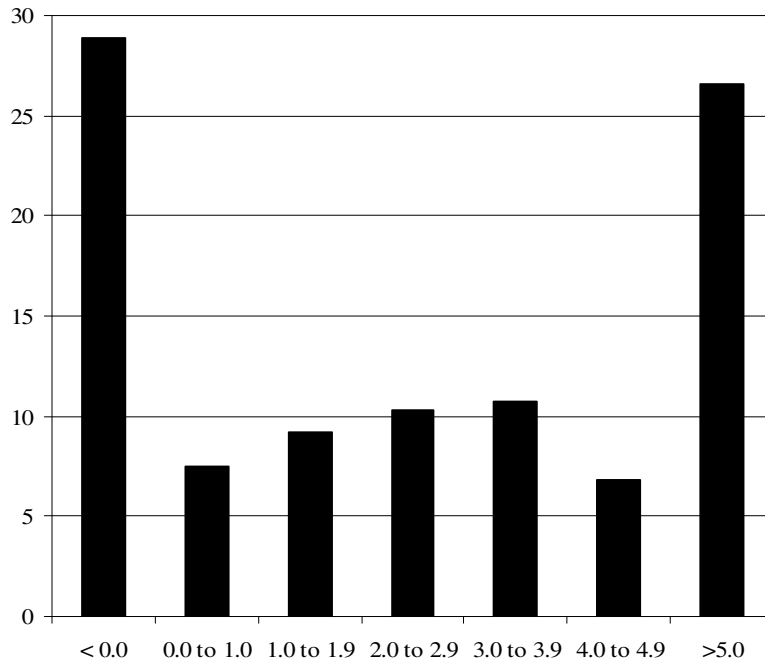
$$\text{Adjusted } R^2 = .036$$

$$\text{F-statistic} = 6.87 \quad (.00)$$

$$\text{Degrees of Freedom} = 778$$

$$\text{Durbin-Watson statistic} = 1.41$$

Figure 3: Distribution of the Difference between LDC and OECD growth rates, across 46 countries, 1990-2008



4. Development Assistance and Recovery of the LDCs

Recent Trends in ODA

In part due to the definition of their status, the least develop countries tend to receive more development assistance than other low income countries. In the second half of the 2000s, the correlation between the level of per capita income of the LDCs and the share of ODA in GDP was negative and significant, albeit rather low.¹³ A more systematic effort by donors to allocate assistance on the basis of national need would make poverty reduction more effective.

When measured in current prices, OECD statistics show a small increase in total assistance to LDCs during the 2000s, though in constant prices the level was almost the same in 2008 as in 2003 (Figure 4). The lack of a substantial increase in the purchasing power of assistance indicates the failure of donors to fulfil the commitments they made in the 2000s (e.g., the Gleneagles meeting).

¹³ A simple logarithmic regression between the share of ODA in GDP and the World Bank's purchasing power parity GDP per capital yields a correlation coefficient of .201, significant at the .00 level of probability. Per capita income is strongly correlated, but explains little of the variation across countries.

As a proportion of the gross domestic product of LDCs, development assistance declined continuously after 2003. For all countries the decline was from almost eight percent in 2003 to less than five in 2008. If two large countries that receive very little aid are excluded (Angola and Bangladesh), the levels are higher but the decline at least as great, from over eleven percent to below seven (Figure 5). A minor but possibly significant reason for the relative decline in assistance to LDCs is the possibility that some statistics over-state the importance of ODA. The levels of ODA by country as reported by the World Bank are substantially higher than those calculated by the OECD (Figure 6). Since the OECD is the definitive source for ODA statistics, the World Bank statistics must be considered unreliable. For almost every LDC the WB reports a higher level of aid as a share of GDP than does the OECD. The difference is substantial, over six percentage points across all countries when Timor-Leste is excluded, which is the only country for which the WB reports a substantially lower statistic.

Across all LDCs, the OECD statistics imply a mean ratio of ODA to total government expenditure of about forty percent (Figure 7). The median value is considerably smaller, less than thirty percent, because of the extreme value for Liberia. *World Development Indicators 2010* provides a calculation of this statistic, and the numbers in that source are unreliable. It should be noted that the OECD statistic does not imply that on average forty percent of government expenditure was financed by ODA. This is because some aid is disbursed by NGOs independently of governments; some goes to debt relief without ever entering the recipient country; and some serves as direct balance of payments support without appearing in the public sector accounts.

For thirty-nine of the LDCs for which there are statistics, the ratio of ODA to GDP is less than twenty percent (Figure 8). For twenty-nine of the countries, almost two-thirds, the ratio was less than ten percent. These numbers suggest that many discussions of ODA to the LDCs tend to exaggerate levels of assistance. For the majority of LDCs, development assistance is equivalent to less than thirty percent of total government expenditure (Figure 9). For only three countries are ODA inflows quantitatively equivalent to the entire public budget (Afghanistan, Liberia and Timor-Leste). However, since some ODA does not go into government expenditure, it is unlikely that assistance inflows are the equivalent of even current public expenditure

for any country other than these three. For the vast majority of LDCs, development assistance contributes to but does not dominate the funding of public expenditure.

ODA through an Aid Fund

If all development assistance were for capital projects, it would be singularly unsuited for supporting government programmes of economic recovery because of its long term and inflexible character. This is discussed in more detail in the next section. Much of ODA finances current expenditure, which in principle could be used to support countercyclical interventions for economic recovery.

However, donors and lenders render development assistance of all types unsuitable for support of recovery programmes because of built-in institutional inflexibility. The *Least Developed Country Report 2000* treated these inflexibilities in considerable detail (UNCTAD 2000), and here the focus is on reliability of allocation and disbursement, or rather, the unreliability of these. Figure 10 demonstrates the extreme instability in ODA disbursements faced by the governments of LDCs in the 2000s. During 2000-2008, the coefficient of variation of annual assistance allocations across LDCs was 43 percent.¹⁴ This was almost three times the variability of the net barter terms of trade of these countries, and for only five of thirty-nine countries were terms of trade fluctuations more severe than ODA instability.¹⁵ Such extraordinary instability, which donors could dramatically reduce, has an extremely debilitating effect on the budget planning of recipient governments.

Donor funding as currently administered does not lend itself to countercyclical programs because of this lack of stability and predictability in delivery.¹⁶ To make their funding more appropriate for countercyclical programs, donors could adjust their allocation procedures to allow for an “aid fund” analogous to national mechanisms

¹⁴ The coefficient of variation is the standard deviation divided by the mean. Here this statistic is multiplied by one hundred and expressed as a percent. Flows by country and the calculation are presented in Annex Table 1.

¹⁵ These five countries were Equatorial Guinea (for which the terms of trade were more variable by four percentage points), Mauritania (2 percentage points), Togo (three), Yemen (two), Zambia (three), and Niger (nineteen).

¹⁶ At the annual Caucus of African governors of the IMF, World Bank and African Development Bank held in Freetown in August 2009, a frequent criticism of IMF and World Bank practice by ministers was the slow-disbursing nature of lending and grant programs. This criticism was directed specifically at three programs of the IMF, the Extended Credit Facility (ECF), the Stand-by Credit Facility (SCF) and the Rapid Credit Facility (RCF). The ECF replaced the Poverty Reduction and Growth Facility (PRGF).

created for resource booms. Money could be drawn from such a fund when the economy is below potential, and “hoarded” when near full potential. Donor grants and loans ear-marked for investment would not be part of such a fund.

The mechanics of a fund need not be bureaucratic. All donors would pay their budget support assistance into a fund held in the central bank of the recipient country, which would have only administrative conditionalities. These conditionalities would be limited to demonstrating that the funds had not been misappropriated. They would have not policy or performance requirements. If donors and lenders were clear on delivery schedules and acted on these, the recipient government could effectively plan its expenditure stream. An important component of this planning would be to phase expenditure to maintain the economy near its potential.

Performance and policy conditionality would render such a fund ineffective for macroeconomic management and little different from the many donor-controlled “trust funds” that undermine recipient attempts to use development assistance effectively. The specific performance conditionalities that should be abandoned are discussed in the concluding section. Underlying these specifics is the more fundamental point that effectiveness of assistance and conditionalities are mutually incompatible and inconsistent with the eighth Millennium development Goal.

The incompatibility arises because the fundamental effect of conditions on assistance is to restrict the freedom of governments to allocate the funds. When assistance was largely to projects, the “fungibility” was persuasive: the specification of the project by a donor released domestic resources that could be used for other projects, some of which the donor might not consider appropriate. However, the growth in importance of budget support with its associated macro conditionalities renders the fungibility argument irrelevant. If, as is the case for several least developed countries, a conditionality is set on the absolute level of government expenditure, the assistance “releases” no domestic resources for any purpose. Limits on the fiscal deficit are only slightly less restrictive.

The constraining nature of conditionalities is treated analytically in Annex 2. At this point it is appropriate to draw the obvious conclusion: conditionalities on budget support should be limited to accounting requirements that protect against fraud and corruption. If this were the case, the design of an Aid Fund would be relatively simple. The most important aspects would involve the standardisation of donor disbursements and recipient reporting. With a robust accounting and monitoring

process, vetted by a third party, the Aid Fund would facilitate rather than restrict national policymaking. How and when funds were spent would be decided by the recipient government. If donors considered this partnership unacceptable, they would limit their assistance to projects which would be conditional upon technical feasibility and rate of return.

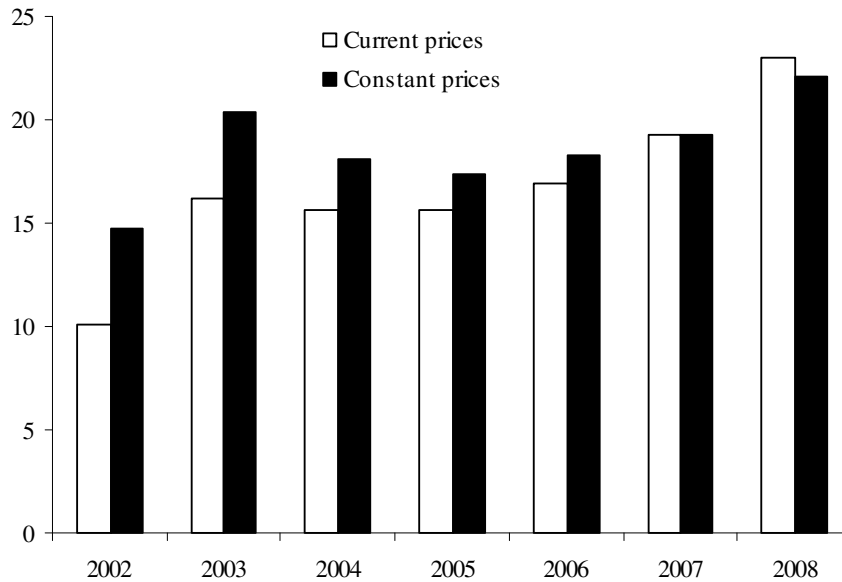
In the second decade of the twenty-first century the arguments for donor conditions on recipient behaviour cannot be technically justified. If the purpose of the assistance and the conditions associated with them is to influence recipient political behaviour, this is inconsistent with the Millennium principle of a Global Partnership for Development. If the purpose is to influence economic policy it is based on one or several arguments generally recognised as false: 1) for each country there is a technically correct economic policy for the moment which donor agencies know; 2) recipients are ignorant of economic policy and cannot make informed decisions; 3) the donor agency knows more about the economic characteristics and needs of the country than the government of the country; 4) the government is aware of correct policies and knowledgeable of its country, but requires the externally specified conditions to avoid the domestic political consequences of the policies; and/or 5) specific interests in the government prevent the choice of correct policies in the absence of donor pressure.

In light of the dramatic shift in economic policy in the developed countries at the end of the 2000s, the first argument cannot be taken seriously. The second argument, ignorance of technical economics, is indefensible empirically, if for no other reason that recipient governments are frequently advised by experts who learned their economics alongside the experts of the donor agencies. The third argument, ignorance of one's own country, is *prima facie* absurd. The fourth, need for an external "scapegoat", is profoundly undemocratic and should motivate no responsible donor. Assistance agencies should not act to protect recipient governments against the wrath of their domestic constituents. If the fifth argument were true, which it may be in some countries, budget support is not appropriate. Further, the final argument implicitly assumes that donor agencies do not have their own special interest which might in part motivate their conditionalities.

An Aid Fund is the vehicle to break with the anti-developmental practice of macro policy conditionalities. It would grant recipient governments the flexibility to

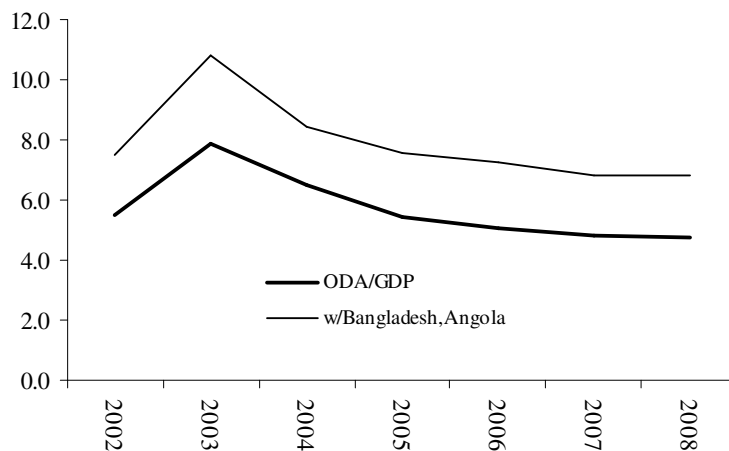
implement a macroeconomic framework that provides the appropriate balance between short term stabilisation of output and long term growth of capacity.

Figure 4: Official Development Assistance to 46 Least Developed Countries, US Dollars billions, Current and Constant Prices, 2002-08



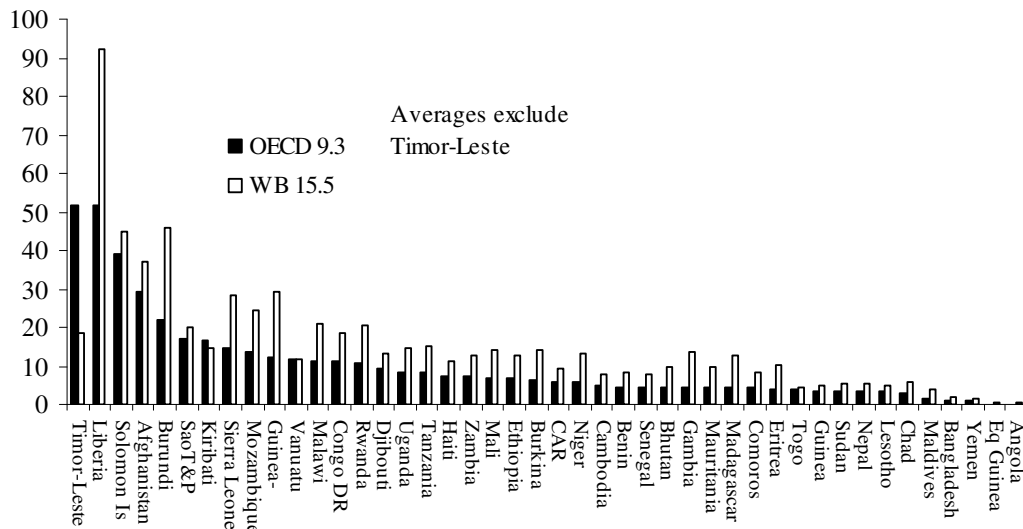
Source: http://www.oecd.org/departement/0,2688,en_2649_33721_1_1_1_1_1,00.html

Figure 5: Official Development Assistance as percentage of GDP, 46 Least Developed Countries, 2002-08



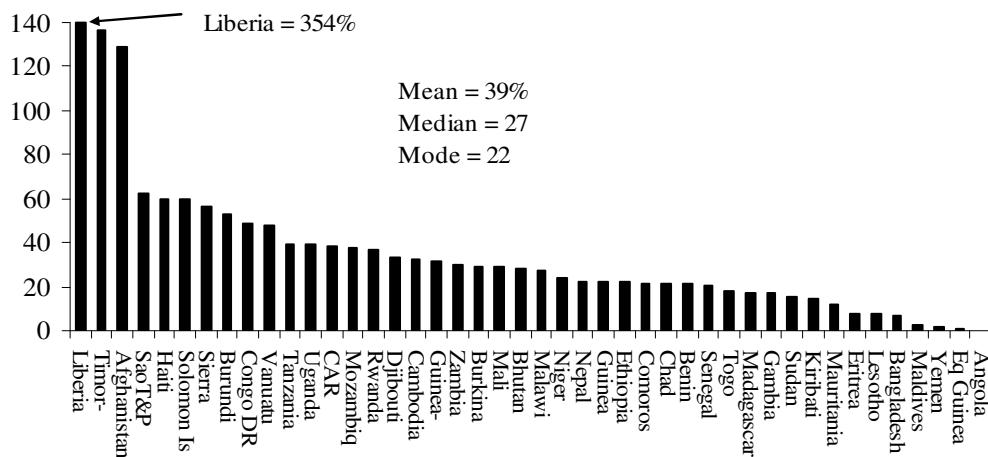
Sources: OECD as above and World Development Indicators 2010.

Table 6: Official Development Assistance as a percentage of GDP, OECD and World Bank Statistics, 44 Least Developed Countries, 2006-08



Sources: OECD as above and World Development Indicators 2010.

Table 7: Percentage Ratio of Official Development Assistance to Total Public Expenditure, OECD Statistics, 44 Least Developed Countries, 2006-08



Sources: OECD and IMF country reports.

Table 8: Number of Countries by levels of Official Development Assistance in GDP, 44 Least Developed Countries 2006-08 (OECD)

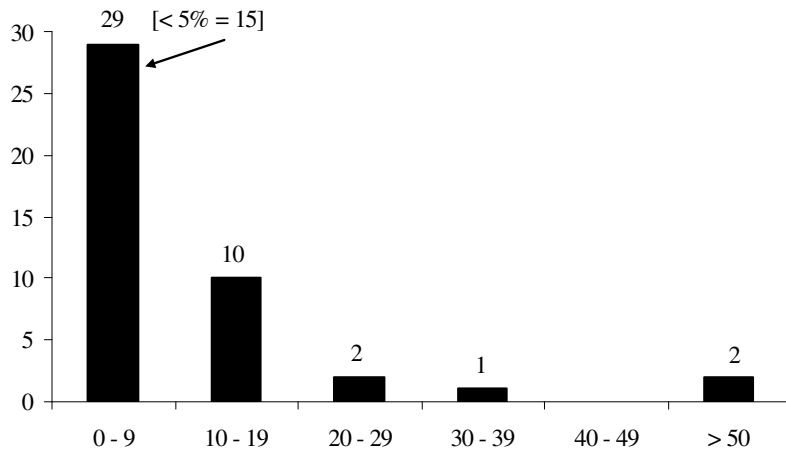


Table 9: Number of Countries by ratio of Official Development Assistance to Total Public Expenditure, 44 Least Developed Countries, 2006-08 (OECD)

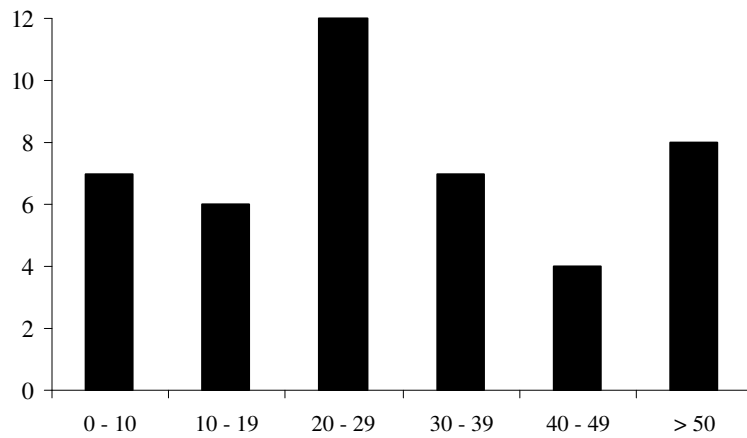
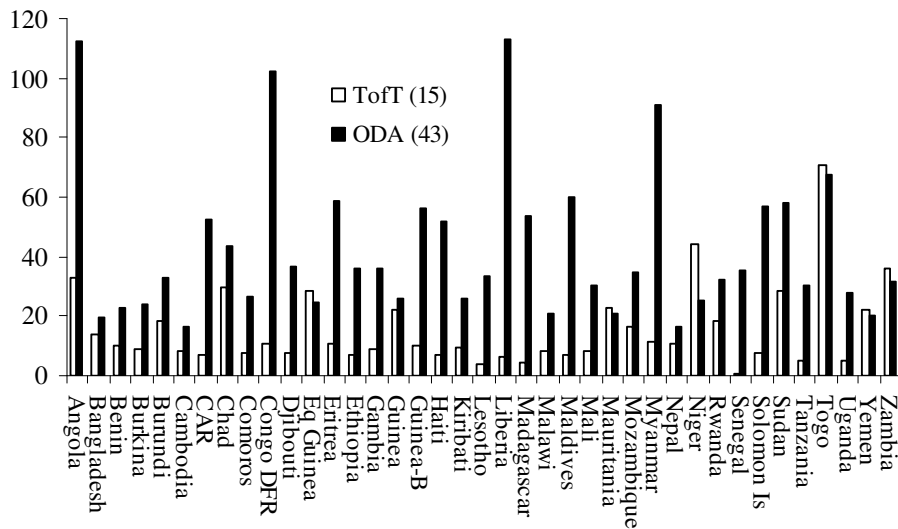


Figure 10: Coefficient of Variation of Development Assistance (current US\$) and Net Barter Terms of Trade, 39 Least Developed Countries, 2002-2008



Source:
 ODA as for previous charts. Net barter terms of trade from World Development Indicators 2010.

Notes:
 Average across countries in parenthesis.
 Coefficient of variation expressed as $100 \times (\text{standard deviation}) / (\text{mean})$.

5. Countercyclical Policy for LDCs

Macro Policy Management

Countercyclical policy increases demand when the economy grows below its long run potential, and decreases it when output encounters resource scarcities that provoke inflationary pressure. This output stabilization policy maintains an economy as close to its potential as is consistent with other goals of policymakers. It is not a growth policy, which would involve public investment to contribute to increasing productive capacity.

To be relevant for the least developed countries, countercyclical intervention requires concrete specification. Reducing taxes would be relatively ineffective because of the nature of the revenue generation. In LDCs personal income taxes are rarely important, with most revenue from taxes on internal commerce, international trade and corporations.¹⁷ Almost all the company tax is collected from foreign

¹⁷ For example, the World Bank data base *World Development Indicators* gives disaggregated tax statistics for eighteen sub-Saharan LDCs in the 2000s. Sales taxes accounted for thirty percent or more for eleven of the countries. Personal and company taxes brought in twenty

enterprises engaged in extractive activities, and reducing their taxes would have little impact on their domestic investment decisions.

The alternative to tax reduction, enhancing demand by public expenditure, requires that the increases are flexible enough to be initiated quickly when there is a demand shock, and terminated with similar dispatch as the economy approaches its potential. Public investments do not meet this condition because of their relatively long and inflexible construction time. Much of current expenditure is also inflexible. For example, it might be possible to increase the number of school teachers if trained people were available, but it might not be rational to terminate them when the economy approaches its potential. If it were judged rational from an educational point of view, it might prove politically difficult.

Because of the inappropriateness of capital expenditure and much of current expenditure of countercyclical intervention, government could base stimulus programs in the LDCs on temporary employment schemes, “cash for work”. Appropriate projects would be rapidly-completed activities using employment intensive techniques that have a large component of repair and maintenance.¹⁸ Examples of such programs are digging sanitation ditches, repair of public buildings, environmental improvement through erosion reduction, and clearing of rural footpaths. These activities were implemented in 2009 throughout Sierra Leone, one of the poorest LDCs, by the National Commission for Social Action as part of a countercyclical policy (Weeks 2009d). The projects would make a contribution to community welfare, though their primary purpose is to increase aggregate demand through the expenditures of those directly and indirectly employed. To be effective, the employment schemes would have the following characteristics:

- 1) identified and “stock-piled” prior to the need for them, with accounting procedures in place to reduce the likelihood of misuse of funds;
- 2) easily initiated and quickly terminated, implying that they should be implemented by the central government in order to avoid delays due to limited administrative capacity of local governments; and

percent or more of revenue in only two of the countries. The source provides no information for the petroleum exporters, Angola, Chad, Equatorial Guinea and Sudan. <http://ddp-ext.worldbank.org/ext/DDPQQ/>

¹⁸ The International Labor Organization calls such projects as “labor-intensive public works”. The ILO website provides further information on short term employment programs. <http://www.ilo.org/public/english/employment/recon/eiip/index.htm>

3) wages and salaries are the major element of expenditure, with a low capital component.

Some issues that plague public works projects with controversy need not be relevant for ones whose purpose is countercyclical. For example, the wage at which workers are paid is a secondary consideration because these are not long term or even medium term employment schemes. The appropriate wage will vary across countries and regions, guided by the principle that the primary purpose of the projects is to increase demand quickly. This would be best achieved by hiring as many people as possible, which implies paying wages at or below prevailing rates. These programs would be introduced when the labour is in excess supply, thus unlikely to affect prevailing wage rates. A ministry of finance study in Sierra Leone recommended this type of employment program as a policy measure to counter the effects of the financial crisis (MoFED-EPRU 2009).¹⁹

Clear rules should be established for the initiation and termination of countercyclical projects. A “countercyclical” expenditure that becomes permanent negates its purpose. Initiation and termination could be triggered by a policy rule based on appropriate macroeconomic indicators. The specific indicator will vary by country, determined by the development and structure of the economy.

Deficit Finance in LDCS

Two technical arguments are used to justify abandoning fiscal policy for economic management: the possible inflationary effect of deficits, and the putative tendency for public borrowing to “crowd out” private by causing interest rates to rise. The relationship between public deficits and inflationary pressures is analytically straight-forward. An increase in spending from any source results in a reduction of expenditure of another type if an economy is at full potential. If the expenditure is by the public sector, its inflationary impact will depend on how it is financed.

The expenditure can be financed through by sales of government securities to the private sector (“open market operations”) or by the ministry of finance borrowing from the central bank (“monetizing the deficit”). For reasons that are not clear in technical terms, this form of finance is viewed negatively by the Bretton Woods

¹⁹ In Sierra Leone the most important cash for work project in 2009 was supported by US\$ 4 million from the World Bank. It employed about 14,000 people in infrastructure maintenance.

organisations which are happy to have governments finance expenditure with the grants and loans they provide, and by funds raised through external bond sales. The money supply impact of monetizing a deficit is no different. In both cases there is net money creation equal to the increase in expenditure. For short term macro policy the difference between the two is that an external inflow increases foreign exchange reserves. This would be an advantage if the government lacks the foreign exchange reserves to cover the change in the current account resulting from the fiscal expansion.

An increase in a public deficit would not be inflationary if financed by bond sales to the private sector, because the net change in the money supply is zero. The government takes money out of circulation by the bond sale, and returns the same amount to circulation through its increased expenditure. Assuming that the private sector holds its desired amount of bonds before the additional public borrowing, the government must offer the bonds above the prevailing interest rate. If the increased bond rate transmits to private financial markets and investment is sensitive to interest rates, “crowding out” results.

This process is of limited relevance to all but a few of the least developed countries because almost all lack private market for public bonds. Those LDCs with bond markets bond sales can have negative side effects which borrowing from the central bank does not. These include increasing the cost of serving the domestic currency debt and discouraging commercial banks from lending for productive purposes (see discussion below).

In contrast, if the government borrows directly from the central bank, the money supply increases and inflation results, with an important exception. In an open economy part of the increased money in circulation will be spent on imports, reducing the inflationary impact, but creating or increasing a trade deficit or reducing a surplus.

If the economy is operating at less than full potential, neither type of deficit financing should generate more than minor and transitory inflation, though “crowding out” could occur. More government expenditure financed by bond sales to the private sector would bring a net increase in aggregate demand. As before, no change in the money supply occurs. Also as before, if the private sector held its desired amount of government debt prior to the bond sale, the new issues must be at a higher interest rate, creating upward pressure on private interest rates, depressing private investment expenditure. The net change in aggregate demand would be positive and less than the

increase in public expenditure unless private investment is extremely interest rate elastic, which is extremely unlikely in most of the least developed countries. Financing the expenditure by direct borrowing from the central bank would not require a higher bond rate. The increase in aggregate demand would equal the increase in public expenditure, and monetizing the deficit generates an increase in the money supply sufficient to circulate the increased output that results from more public expenditure.

As discussed further in the next section, few least developed countries have sufficiently developed bond markets to allow for effective open market operations. In the absence of an effective secondary bond market the major motivation of commercial banks to hold public bonds is statutory requirements on the composition of reserves. This implies that high interest rates are required to induce banks to purchase bonds beyond their legal obligation. The absence of a secondary market and high yields on public bonds means that financing deficits by bond sales has the perverse effect of discouraging commercial banks from funding productive investments, which are riskier than holding government securities.²⁰ A second major effect of high interest rates is to increase the cost of servicing the domestic public debt.

With the economy well below its potential, monetizing the deficit is an effective tool for the expansion of aggregate demand, generating neither inflation nor “crowding out” of private expenditure. The government’s expenditures on infrastructure could be consciously designed to “crowd in” private investment by lowering costs of transport, electricity and water supply.²¹ In many LDCs, Zambia, for example, the increased cost of servicing the public debt as a result of bond sales should be a greater concern than inflation or “crowding out”.

²⁰ This process is discussed in detail for Zambia in Weeks, *et. al.* (2006). This represents what might be called “bank squeezing out”. The typical use of the term “crowding out” refers to a fall in private investment that results from government borrowing that pushes up interest rates, discussed in the previous section. More relevant in sub-Saharan countries is the decision by private banks not to lend because the risk-adjusted return on public bonds is greater than that for lending to private non-financial borrowers. The return on public bonds is high because of the oligopsonistic power of private banks in low-income countries.

²¹ An example is the repair of the Bumbuna hydroelectric site, which could greatly reduce power cuts and private generators in Sierra Leone, especially Freetown. See <http://siteresources.worldbank.org/EXTDEVCOMMENG/Resources/sierraleone.pdf>

Exchange Rate Management

Fiscal expansion, by increasing output and private demand, will increase imports and generate a trade deficit or make an existing deficit larger. This is one of the problems that undermined the use of active fiscal policy in developing countries in the past and discredited it as an instrument of macro management, especially in Latin America in the 1970s. Exchange rate depreciation or devaluation can be used to counter the tendency of fiscal expansion to create an unsustainable trade balance.

Thus, depreciation or devaluation is an intended part of a countercyclical policy, and causes a rise in the domestic price level equal to at least the “pass-through rate” (marginal propensity to import) times the change in the nominal exchange rate. While necessary and intended, this exchange rate induced increase in the price level creates the risk of destabilizing inflation if the nominal devaluation is large. Managing this risk is an essential part of a successful active fiscal policy.

As fashion moved against active fiscal policy over the last three decades, there was a shift to a view that “flexible” exchange rates were the only practical policy choice for governments. Therefore, it is necessary to explain why exchange rate management by LDC governments would be both feasible and possible as part of policy to counter the global crisis.²² In practice almost all governments intervene in foreign exchange markets.²³ The policy choice is not between “fixed” and “flexible” exchange rate regimes, but selection of the most appropriate point on a range of forms and degrees of intervention in the context of the characteristics of the economy (Fischer 2001). Governments and central banks repeatedly shift between “flexible” and “fixed” exchange rates.²⁴ Any time a central bank intervenes to moderate the rise or fall of the national currency it is “fixing” the exchange rate, however briefly.

²² An argument in favor of a return to managed exchange rates is found in Rolnick and Webber (1989), who write, “[W]e maintain there is a convincing case that a fixed exchange rate system is feasible and should be established. Theory shows it feasible, and overlooked empirical evidence shows it possible.”

²³ The IMF categorizes countries by exchange rate regime, and the Annual Report for 2007 lists only thirty-five out of over 150 as having an “independently floating” exchange rate. Only two were in the sub-Saharan region, Democratic Republic of Congo and Somalia. The listing of the latter seems an anomaly because Somalia has no government and no currency. Another anomaly is the absence of Sierra Leone from the table.

²⁴ Exchange rate management is treated in Rolnick and Webber (1989) and Bartolini and Prati (1997). An IMF Staff Paper from the 1970s shows how much the conventional wisdom has moved against exchange rate management (Lipschitz 1978).

The exchange rate management that would be part of the proposed stimulus package would not seek to maintain a “fixed” rate for the domestic currency against any foreign currency. The purpose of the intervention would be to control the rate of depreciation of the national currency against the currencies of major trading partners in order to prevent a widening of the trade gap as the economy expanded, and prevent excessive weakening that would stimulate unmanageable inflation. The exchange rate managers would face two possible contexts, one in which the fiscal expansion is accompanied by no “weakening” of their currency and another in which fiscal expansion automatically provokes depreciation.²⁵

The *devaluation case* occurs if there is no market pressure to weaken the national currency as public expenditure increases. The government must act directly on the exchange rate to raise the price of tradables, which will reduce import demand and raise the return to exporters. The mechanism for exchange rate management will differ with the characteristics of financial and foreign exchange markets in each country. In effect, the government would temporarily be implementing a “crawling peg” exchange rate regime. The *depreciation case* occurs if the fiscal expansion is accompanied by market pressure to weaken the currency. While the market pressure to weaken the exchange rate serves the government’s purpose of increasing competitiveness, intervention is potentially necessary to prevent the currency from depreciating at a rate that generates unmanageable inflation pressures.²⁶

In summary, the exchange rate can be an effective policy instrument for supporting a fiscal stimulus, especially important if monetary policy is ineffective. This effectiveness is limited by potential inflationary effects. However, for many governments least developed countries, especially in the sub-Saharan region, exchange rate policy is precluded by currency arrangements, as discussed in the next section.

Feasibility of a Fiscal Stimulus

If a government could effectively use all its policy instruments the design of the stimulus package would follow the standard textbook prescription: an increase in

²⁵ The well-known Fleming-Mundell model predicts that a fiscal expansion would result in exchange rate appreciation. That analysis is not relevant to most LDCs because the countries have no significant level of portfolio flows due to lack of the necessary financial institutions. Theoretical problems in the model are discussed in Weeks 2009b.

²⁶ Exchange rate management in Zambia is discussed in detail in Weeks, *et. al.* (2007).

expenditure or a reduction in taxes would provide the principle demand stimulus; the exchange rate would be managed to prevent deterioration in the external current account; and the fiscal deficit would be financed in part or entirely by public bond sales to the private sector to prevent excessive money growth. For countries that export commodities that are exchange rate inelastic, such as petroleum, currency adjustment would only affect imports.

The policy options facing the governments of the least developed countries are considerably more restricted than this, as Tables 3-6 show. If we ignore restrictions set by donors and lenders, policy space is restricted by two types of constraints, institutional and economic. As the first column of Table 3 shows, very few least developed countries have the institutions to implement monetary policy. As summarized in Table 4, fourteen countries were part of a common currency zone or operated with an inflexible link to another currency. Of the thirty-one countries with national currencies, a majority did not issue bonds or had no formal bond market.²⁷ For all the LDCs, only five had secondary bond markets and none of these were effective and efficient.²⁸ For practical purposes, monetary instruments are of little use in the LDCs. Raising and lowering the central bank rate would have little effect on inflation because of the absence of links to private credit creation.

Though less limited than monetary policy, exchange rate adjustment is not available to a substantial number of governments, because, as noted above, fourteen have a common currency or fixed link. The remaining thirty-one operated with adjustable fixed exchange rates or “flexible” rates. The vast majority of these thirty-one had no bond markets in which sterilization operations could be implemented. For several of the twenty-seven, exports would be exchange rate insensitive (e.g., the petroleum exporters).

With regard to fiscal policy (Table 6), the LDCs of the West African Economic and Monetary Union and Central African Economic and Monetary Community (so-called CFA zone) had restrictions on fiscal operations that required the governments to balance the annual current budget. The capital budget could be in

²⁷ The most accessible source for information on monetary institutions and financial markets in Africa is the Wharton Financial Institutions Center of the University of Pennsylvania, which provides recent reports on almost all countries. See <http://fic.wharton.upenn.edu>. For countries in Africa not covered in Wharton studies, websites of central banks were used.

²⁸ For example, the government of Zambia issues bonds and the Bank of Zambia conducts open market operations. However, the market for these bonds is narrow, limited to a few expatriate banks (Weeks, *et. al.* 2006, Chapter 6).

deficit if the method of finance were specified. While this arrangement does not exclude a fiscal stimulus, in practice it greatly restricts it. The *sin qua non* of countercyclical intervention is that it can be initiated and terminated quickly in response to demand shocks. Capital expenditures lack this flexibility.

In addition to these primary institutional constraints on policy tools, there are the secondary ones stressed by the IMF, performance indicators. Some initial conditions would be so unfavourable as to render a stimulus package unwise because it would generate macro instability rather than recovery. In general, a stimulus policy should be consistent with a sustainable fiscal balance, manageable external current account and inflation which is not destabilizing. The initial values of these variables which are consistent with macroeconomic stability will depend on the structural and behavioural characteristics of each economy and the size of the stimulus to be implemented. In this context, the most important behavioural characteristics are the exchange rate elasticity of trade, the propensity to import, the income elasticity of public revenue, and the level of structural inflation.

On the basis of the average import propensity and inflation rates for the region, and assuming low elasticities of trade and public revenue, the following performance guidelines are proposed. Prior to the implementation of the stimulus package,

1. the fiscal balance after concessionary finance (ODA) should not exceed five percent of GDP;
2. the external current account deficit should be covered by ODA, and/or foreign exchange reserves should be at least three months of imports; and
3. inflation should not exceed fifteen percent per annum except in the case of a fiscal surplus.

Table 6 combines these performance constraints with the previously discussed institutional limits on policy implementation to identify the stimulus packages that would be feasible for the governments of the least developed countries. Whether it would be appropriate to do so requires individual country analysis. For sixteen countries it would be feasible to implement a combined fiscal expansion and exchange rate management package. Despite its high inflation rate of eighteen percent, Angola is included in this group because of the country's large fiscal and current account surpluses. In most of these countries it would be necessary and rational to monetize the increase in the fiscal deficit.

The practicality of implementing a stimulus was indicated when two governments of LDCs set examples for the others by initiating such packages in 2009 or 2010.²⁹ The IMF supported the countercyclical intervention in Mozambique, even though the government's fiscal deficit was over three percent of GDP and the external current account balance was almost minus nine percent of GDP. Almost all the countries in Table 3 that would use both fiscal and exchange rate instruments had smaller negative balances after ODA inflows.

For four countries exchange rate management would not be possible due to currency arrangements, but their budget and current account balances allow for fiscal expansion (see Table 6). Fiscal expansion would threaten neither internal nor external stability. In ten countries a fiscal expansion would require external concessional finance because of limits on deficit financing. In eleven other countries the performance indicators do not justify a stimulus policy.

To summarize (see Figure 11), in twenty of the forty-five countries a domestically financed fiscal stimulus would be feasible and justified by the most recent performance indicators. The performance indicators for ten more countries do not preclude a stimulus, but it would require external assistance because of the current account impact in the context of exchange rate inflexibility. Eleven countries require a stabilization program to move towards internal and external balance before a stimulus would be sustainable.

²⁹ These are Sierra Leone (Weeks 2009d) and Mozambique (IMF 2009c). A low-income non-LDC case was Nigeria (Alabi and Adams 2010).

Table 3: Macroeconomic Indicators and Policy Tools Available to Governments of 46 LDCs, Late 2000s

Country	Monetary policy	Fiscal policy	Exchange rate policy	Fiscal deficit	Crr Acc deficit	Forex reserves	ODA/GDP	Inflation
1. Angola	NSM		Managed	6.5	19.3	4.2	0.9	18.2
2. Benin	NCB	Constrained	WAEMU	-0.2	-5.0	7.0	8.3	4.5
3. Burkina Faso	NCB	Constrained	WAEMU	-5.0	-11.2	na	13.9	2.1
4. Burundi	NSM		Managed	-1.9	-13.7	4.1	46.8	13.5
5. Cen Afr Rep	NCB	Constrained	CAEMC	-0.5	-8.2	na	8.8	3.6
6. Chad	NCB	Constrained	CAEMC	-1.9	-2.0	na	6.5	10.7
7. Comoros	NSM		Fixed (Euro)	-2.0	-5.0	na	7.8	3.7
8. Congo DR	NSM		Managed	-2.0	-26.4	na	21.5	18.1
9. Eq Guinea	NCB	Constrained	CAEMC	21.0	5.7	na	0.6	19.9
10. Eritrea	NSM		Fixed (US\$)	-30.0	-12.0	na	17.4	17.5
11. Ethiopia	NSM		Managed	-7.6	-8.2	2.1	13.7	16.8
12. Gambia	NSM		Managed	0.5	-10.5	4.3	14.3	3.8
13. Guinea	NSM		Fixed (US\$)	-3.3	-8.0	na	5.4	18.0
14. Guinea-B	NCB	Constrained	WAEMU	-19.1	2.4	na	28.9	5.8
15. Lesotho	CMA		CMA (rand)	8.7	8.5	4.8	4.7	7.9
16. Liberia	NSM		Fixed (US\$)	0.3	-28.5	0.6	80.2	12.8
17. Madagascar	LSM		Managed	-2.6	-10.0	2.7	14.8	12.3
18. Malawi	LSM		Managed	-2.5	-5.5	na	21.0	13.4
19. Mali	NCB	Constrained	WAEMU	8.0	-6.2	4.6	14.2	6.1
20. Mauritania	NSM		Managed	-5.0	-20.0	na	10.2	15.1
21. Mozambique	NSM		Managed	-3.4	-9.9	3.8	23.5	8.5
22. Niger	NCB	Constrained	WAEMU	12.5	-8.0	3.3	14.1	5.1
23. Rwanda	LSM		Managed	-0.2	15.0	6.8	22.2	11.7
24. Sao Tome & P	NSM		Managed	-14.0	nd	nd	23.4	17.9
25. Senegal	NCB	Constrained	WAEMU	-1.5	-10.4	3.6	8.2	4.9
26. Sierra Leone	NSM		Managed	-5.0	-8.6	4.3	29.4	11.7
27. Sudan	NSM		Managed	-0.4	-10.1	1.5	6.1	10.4
28. Tanzania	NSM		Managed	-3.5	-9.6	5.3	13.7	10.9
29. Togo	NCB	Constrained	WAEMU	-3.4	-15.3	2.1	4.2	1.8
30. Uganda	LSM		Managed	-1.0	-5.9	6.9	14.7	3.6
31. Zambia	LSM		Managed	-1.1	3.8	3.1	14.2	13.3
32. Djibouti	NSM		Fixed (US\$)	nd	-2.2	3.0	13.3	3.1
33. Haiti	NSM		Managed	nd	-1.4	2.0	11.2	14.0
34. Cambodia	NSM		Managed	-0.8	-8.6	3.3	8.2	7.8
35. Kiribati	NSM	Constrained	Fixed (Aus\$)	nd	nd	nd	16.0	2.7
36. Solomon Is	NSM		Managed	nd	nd	nd	18.1	7.8
37. Timor-Leste	NSM		Managed	nd	nd	nd	21.4	11.0
38. Vanuatu	NSM		Managed	-2.3	-7.1	4.6	11.9	4.9
39. Yemen	NSM		Managed	-1.2	-3.0	9.1	1.5	15.4
40. Afghanistan	NSM		Managed	-1.7	nd	nd	37.6	7.8
41. Bangladesh	NSM		Managed	-1.3	1.6	2.8	2.0	6.3
42. Bhutan	NSM	Constrained	Fixed (Rupee)	-4.8	nd	nd	8.9	4.0
43. Laos	NSM		Managed	-2.4	1.8	5.8	10.2	5.7
44. Maldives	NSM		Fixed (US\$)	-9.9	-36.2	2.7	4.0	10.0
45. Nepal	NSM	Constrained	Fixed (Rupee)	-1.0	0.9	7.2	5.7	6.9
46. Myanmar	NSM		Fixed (US\$)	-2.3	nd	4.0	0.0	20.2
	6/46	33/46	31/46					

Notes to Table 3:

Samoa, Somalia and Tuvalu omitted due to lack of data.

Shaded cells indicate values or characteristics that restrict policy options.

Indicators for 2006-07, except Myanmar (2002-03) and Afghanistan (2000-01).

Fiscal deficit is the cash deficit as a percentage of GDP.

Crr Acc deficit is the current account of the balance of payments as percentage of GDP.

Forex reserves are central bank holding of foreign exchange measured in the number of months of imports.

ODA/GDP is official development assistance (OECD definition) as percentage of GDP.

Inflation is the annual rate of change of the GDP deflator.

The first three cells of the final row give the number of countries out of the total for which each policy instrument is feasible. The next cells give the number of countries whose fiscal policies are constrained by the recent values of the five indicators. Fiscal expansion is not feasible if: the fiscal deficit exceeds the share of ODA in GDP by more than five percentage points; the current account deficit exceeds the ODA share by more than five percentage points; foreign exchange reserves are less than three months of imports; and/or inflation exceeds fifteen percent.

Acronyms:

The so-called CFA franc zone is the West African Economic and Monetary Union (WAEMU, Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo). In addition to a common currency the governments of these countries are constrained to balance the current account of the public budget. The capital account can have a deficit if the method of funding the deficit is specified. The Central African Economic and Monetary Community (CAEMC, Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon) also has a common currency with a fixed parity to the euro. Both are commonly called the CFA franc. They are not freely interchangeable, except via euro convertibility that is guaranteed by the French Treasury, which holds at least sixty-five percent of the pooled reserves of each area.

CMA is Common Monetary Area, rand (South Africa, Lesotho, Namibia, Swaziland)

NCB is no central bank, including countries sharing a common central bank.

NSM is 'no secondary market' which includes cases in which the government does not issue bonds, issues them but does not sell them on the open market, or sells them but there is no secondary (resale) market.

LSM is 'limited secondary market' and refers to the number of buyers and sellers.

Sources:

Monetary institutions: Wharton Financial Institutions Center of the University of Pennsylvania, all but Mauritius, Namibia, Nigeria and Seychelles, and <http://www.afdb.org/en/news-events/article/donor-workshop-on-african-bond-market-4443/>

Economic indicators: *World Development Indicators 2009* and IMF country reports.

Table 4: Least Developed Countries, Monetary Institutions, 2010

Category	Countries	Notes
Common Currency	14	CFA, BEAC, CMA
National currency	32	fixed or managed
No bond market	41	no bonds or no re-sale market
Bond market	5	formal re-sale market
Narrow	5	usually commercial banks only
Effective	0	

Table 5: Least Developed Countries, Exchange Rate Regimes, 2010

Category	Country count	Notes
Common Currency	14	CFA zone (7), Central Africa (3), CMA (1), Rupee (2), Aus\$ (1)
Single currency, fixed	7	US\$ (6), Euro (1), none with bond market
Single currency, managed	25	5 with bond market
Feasible managed floats or pegs	32	

Table 6: Least Developed Countries, Fiscal Stimulus Summary, Late 2000s

Stimulus constraint	Countries
1. Excluded from domestic financing, must balance current budget	(13) Benin, Burkina Faso, Guinea-Bissau, Mali, Niger, Senegal, Togo, Central African Republic, Chad, Equatorial Guinea, Kiribati, Bhutan, Nepal
2. Excessive fiscal deficit (Fiscal deficit - ODA) < (-5% GDP)*	(2) Eritrea, Maldives (5 no data)
3. Excessive current account deficit (Current account - ODA) < (-3.0% GDP)*	(4) Congo DR, Guinea, Mauritania, Togo, Maldives, 5 no data
4. Inadequate forex reserves (Forex reserves) < (3 months of imports)	(5) Ethiopia, Liberia, Madagascar, Sudan, Togo, Haiti, Maldives
5. Excessive inflation [Inflation over 15%]*	(4) Angola, Congo DR, Eq Guinea, Eritrea, Ethiopia, Guinea, Mauritania, Sao Tome & Principe, Sudan, Togo, Haiti, Yemen, Maldives, Myanmar
6. Other (conflict and natural disaster)	(1) Afghanistan, Congo DR, Haiti
Feasibility of a Fiscal Stimulus	
1. Feasible: Domestically financed fiscal expansion with exchange rate management	(17) Angola, Burundi, Comoros, Gambia, Malawi, Mozambique , Rwanda, Sierra Leone , Sudan, Tanzania, Uganda, Zambia, Djibouti, Cambodia, Timor-Leste, Bangladesh, Laos
2. Feasible: Domestically financed fiscal expansion, no exchange rate management [fiscal surplus, sustainable current account]	(4) Equatorial Guinea, Lesotho, Mali, Niger
3. Feasible: Externally financed fiscal expansion, no exchange rate management	(9) Benin, Burkina Faso, Chad, Guinea-Bissau, Senegal, Kiribati, Solomon Islands, Bhutan, Nepal
4. No stimulus feasible: excluded by fiscal deficit, current account deficit or inflation	(16) Afghanistan, Congo DR, Eritrea, Ethiopia, Guinea, Haiti, Mauritania, Togo, Liberia, Madagascar, Maldives, Sao Tome & Principe, Sudan, Vanuatu, Yemen, Myanmar

Countries in bold initiated fiscal stimulus in 2009 or 2010.

*Number in parenthesis refers to those countries not previously excluded.

Angola and Equatorial Guinea are placed in the category of a feasible stimulus despite their inflation rates because of their public sector and current account surpluses.

1. These are the 14 “common currency” countries in Tables 4 and 5. Their currency arrangements prohibit them from having current account deficits (the African countries except for Lesotho), or this is the de facto result of bilateral aid arrangements (Bhutan, Nepal, Kiribati).

2. The fiscal deficit is judged to be “excessive” if after ODA it exceeds five percent of GDP. This judgement is based on the implied accumulation of internal debt.
3. The current account deficit is judged to be “excessive” if after ODA it exceeds three percent of GDP. This judgement is based on the implied accumulation of external debt.
4. Forex holdings of less than three months of imports are judged as too small to sustain the increased imports implied by a fiscal stimulus.
5. Inflation in excess of fifteen percent per annum is judged as destabilizing and inconsistent with the greater nominal demand implied by the fiscal stimulus.
6. These countries are judged to be too conflict-affected (natural disaster in the case of Haiti) to have the productive flexibility to respond to a fiscal stimulus.

Figure 11: Countercyclical Feasibility in Least Developed Countries in response to the global crisis

Global financial crisis causes world recession. LDC governments respond:		
Initial conditions allow for Fiscal expansion >>	GDP recovers but Increased imports weaken external current account >>	
	Current account corrected by devaluation.	(16) Angola, Burundi, Comoros, Gambia, Malawi, Mozambique, Rwanda, Sierra Leone, Sudan, Tanzania, Uganda, Zambia, Djibouti, Cambodia, Timor-Leste, Bangladesh
	No current account correction needed (in surplus)	(4) Equatorial Guinea, Lesotho, Mali, Niger
	Current account must be covered by ODA	(10) Benin, Burkina Faso, Central African Rep, Chad, Congo Rep, Guinea-Bissau, Kiribati, Solomon Islands, Bhutan, Nepal
	Initial conditions preclude fiscal expansion	ODA required to support stabilization that is not poverty increasing
Conflict and natural disaster countries requiring special UN programmes	Peacekeeping, infrastructure reconstruction, public health, demobilization, relocation	(4) Afghanistan, Congo DR, Haiti, Somalia

6. Long Term Growth and Development in LDCs

Public Investment

Every government seeks to maintain a fiscal policy that has manageable deficit, an associated public debt that is serviceable, an inflation rate consistent with other policy goals, and a sustainable balance of payments. However, “sound fiscal policy” involves much more than this. The economic function of government is not merely to maintain a stable macro environment. Its primary responsibility to its citizens is to foster the general welfare. Fiscal deficits should not be treated in a manner undermines a government’s ability to achieve the general welfare. The general welfare of the population implies maintaining the economy near its potential in the short run and increasing its capacity to growth in the long run. The first is achieved through countercyclical fiscal intervention with accommodating monetary and exchange rate policies, and the second through public investment in productive capacities.

An active fiscal policy is the major instrument to generate a pattern of growth that maximises poverty reduction subject to the circumstances that constrain policy in each country. Fiscal policy should foster achievement of the Millennium Development Goals, which implies that the poor, however defined in the national context, disproportionately benefit in each period’s growth increment. Achieving this outcome requires measures that assure the pro-poor distribution of that increment, by fostering faster growth that is employment intensive. A government that seeks strong growth should never adopt measures that constrain it from implementing an active and innovative fiscal policy. The key fiscal measures to foster growth are maintaining the economy near its potential in the short term and using public sector investment to foster growth through ‘crowding in’ effects.

Targets for fiscal deficits have the effect of decommissioning public expenditure and taxation as macro-management tools.³⁰ Liberating fiscal policy from a deficit target

³⁰Let t be the tax rate, c the propensity to consume, and n the propensity to import. Using the standard notation for national income (Y), consumption (C), private investment (I), government expenditure (G), exports (X) and imports (N), we can write:

$$\begin{aligned} Y &= C + I + G + (X - N) \\ &= c(1-t)Y + I + G + (X - nY) \end{aligned}$$

is the essential step for an effective public investment programme to foster growth and diversified development in least developed countries. Pressure to meet a deficit target becomes extremely contractionary when combined with a restrictive monetary policy, because the former constrains public investment while the latter constrains private investment.

Public investment will always be growth-inducing both in its demand and capacity effects, unless the return on the marginal private component were sufficiently higher to outweigh the growth effect of the marginal public component. This can be shown formally by using a 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, respectively. Without public investment, the warranted (potential) rate of growth of the economy is:

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

Let the ‘crowding out’ ratio be α (the fraction by which public investment reduces private investment). Then, the new growth rate with public investment is:

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

Subtracting y_0 from y_1 , one gets:

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

$$\Delta y = [i_{pu}] [v_{pu} - \alpha v_{pr}]$$

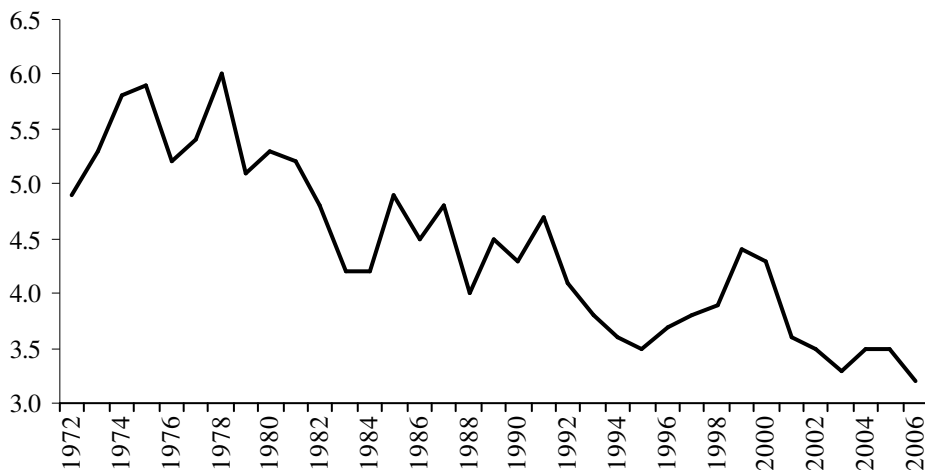
Crowding out will reduce the rate of growth if and only if, $v_{pu} < \alpha v_{pr}$. If the capital-output ratio for public investment is no larger than for private investment, public investment never reduces the growth rate, no matter what the value of α , assuming its upper limit to be unity (“total 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 increasing productive capacity occurs only under the very restrictive conditions that 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.

Let $G = b(tY)$, where $b > 1$, and the deficit target is $(1 - b)$. Therefore, G is rendered endogenous and the multiplier is $m = 1/[1 - c - t(b - c) + n]$.

$$Y = m[I + X]$$

Despite the obvious need in least developed countries for public investment, ideological fashion has moved against it. This is especially the case in the sub-Saharan region where Washington Consensus type macro policies have strongly discouraged an active public sector role in fostering growth. Figure 10 provides what extended time series statistics are available for the average share of public investment in GDP, across fifteen sub-Saharan countries over more than three decades. In the 1970s, the average for these countries was between five and six percent of GDP. A long decline followed, to well below four percent in the 2000s. Such extremely low public investment rates go far to explain the deterioration of infrastructure in the least developed countries of the sub-Saharan region, as well as low growth rates.

Figure 10: Fifteen sub-Saharan Countries: Public Investment as Percentage of GDP, 1972-2006



Source: World Development Indicators 2009 and IMF country reports.
 Countries: Botswana, Burkina Faso, Cameroon, Congo, Cote d'Ivoire, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mauritius, South Africa, Swaziland, Uganda, Zimbabwe.

Domestic Finance

Development assistance can complement domestic resources for infrastructure development, but it cannot be a substitute, or even serve as the principal source of development finance in the long term. A central element in any development strategy for least developed countries is to raise domestic resources for public sector expenditures,

both current and capital.

The hypothesis that development can be achieved with “small government” is flawed, as inspection of public sector share in GDP quickly reveals. As the level of development rises, so does the capacity of the public sector to raise revenue and borrow. Capacity to raise revenue increases because the shift from informal to formal economic institutions implies a shift from self employment to wage employment, with the latter more easily taxed. Borrowing becomes easier because the development of financial institutions creates the market for public bonds.

Domestic borrowing for public investment has been an important source of resource mobilisation for growth and development in all of the currently developed countries, as well as in many developing ones. While domestic borrowing to finance government consumption is widely recognised as undesirable, domestic borrowing for appropriate public investments with demonstrable returns in terms of socio-economic and human development are regarded as perfectly acceptable in most developed countries. The rules for fiscal deficits advocated by then British Chancellor Gordon Brown allowed for borrowing for critical public investments.

However, the freedom for manoeuvre in borrowing is often not available to developing countries as a direct consequence of policy conditionalities that place severe curbs on domestic borrowing without reference to whether such borrowing finances consumption or investment. For example, if strictly obeyed IMF restrictions on external debt accumulation by the Ethiopian government in the late 2000s would have precluded government-to-government concessionary loans.³¹

External borrowing for public investment should be distinguished from ODA itself even when it is government to government. Public borrowing for investment should be judged on the basis of 1) the anticipated return discounted by the borrowing charges, and 2) the aggregate demand implications. The first determines whether the investment will generate the income flow to repay the debt it creates, and the latter assesses whether the investment would generate excessive monetary demand. In general externally financed investments do not worsen the balance payments in the short run because the import cost is subsumed within the borrowing.

³¹ See the discussion of external debt in the Letter of Intent of August 2009 (IMF 2009e, 9ff).

It is unfortunately the case that these sensible and obvious rules for external borrowing which in the past characterised the lending operations of the multilateral development banks have been superseded by highly restrictive IMF rules on external debt limits. At a meeting of African governors of the IMF, World Bank and African Development Bank in August 2009 held in Freetown, Sierra Leone, the finance ministers issued unanimously the Freetown Declaration which called for the IMF to abandon imposing such limits and “support our policy frameworks [and give] us the needed policy space...to leverage resources”.³²

While external borrowing for public investment is viewed with great caution by the IMF, the organisation’s attitude to domestic borrowing in least developed countries is unambiguously negative. This predilection against domestic borrowing results from an unqualified opposition to “monetisation” of deficits. As discussed above, deficit finance is monetised if the government borrows directly from the central bank rather than selling public bonds to the private sector. Because of the near non-existent financial markets, governments in least developed countries have no choice but to finance deficits domestically by monetisation. The orthodox dislike of monetisation results from the alleged inflationary consequences of the implied growth of the money base.

In an earlier section the dysfunctional consequences of bond sales to the private sector were demonstrated and are not repeated here. Even more important than that argument against bond sales is the intrinsic inconsistency of the orthodox opposition to monetisation. None of the multilateral development bank nor the IMF object to governments financing public investment by development assistance. The expenditure for any domestic purpose of development assistance by a government results in a net increase in the monetary base equal to the expenditure unless accompanied by central bank “sterilisation” intervention, which the IMF rarely requires (and for most least developed countries could not require). It is difficult to imagine a more glaring and analytically invalid policy position: support for expenditure of ODA which augments the

³² Page one of the Freetown Declaration, which can be found in full at the following website, http://www.mofed.gov.sl/index2.php?option=com_content&do_pdf=1&id=99

money supply, but complete intolerance for domestic borrowing that has the same effect.³³

Role of ODA in Public Investment

It is obvious that official development assistance can serve as an important source of finance for investing in human and physical resources. The choice of verb, “can serve”, is quite important, because donor conditionalities and “benchmarks” frequently have the effect of severely reducing the effectiveness of ODA. The same ideologically driven policies that have restricted the role of the public sector in development have also undermined the effectiveness of ODA.

In this context it is instructive to focus on the sub-Saharan region, which with the exception of a few Least Developed Countries elsewhere it includes the countries of the world most dependent on ODA. After over a decade when the constant price level of ODA stagnated, ODA increased substantially in the mid-to-late 2000s (see Figures 4 and 5). Because part of this increase was debt relief, it is difficult to assess the budgetary implications. To some degree it increased the resources available to LDC governments to fund public investment, though some of these governments were constrained from doing so by on-going policy conditionalities. Of the many complaints about the IMF expressed by African finance ministers at the Freetown meeting, the most frequent involved restrictions of policy making. One long serving finance minister from a least developed country stated that African governments “knew what policies were needed, so leave us alone to implement them”.³⁴

In addition to all its other problems, involving non-predictability of allocations, lack of reliability in disbursements and bureaucratic delays, the development potential of ODA suffers from what it seeks to fund. Table 7 reports OECD statistics on the categories of ODA expenditure in 2008. For bilateral agencies, eighty-four percent of ODA went to current expenditures and sixteen percent for capital projects. The

³³ It can be argued that development assistance is to be preferred because it is associated with an inflow of foreign exchange, which domestic finance is not. While this is true, it does not affect the analytical conclusion that both forms of finance have the same monetary impact.

³⁴ Private communication at the Freetown Caucus of African Governors of the IMF, World Bank and African Development Bank.

assistance from the European Commission had a larger capital component, twenty-four percent, and World Bank funding larger still, at thirty-seven percent. All of IMF concessional lending (not in the table) enters current expenditure, as budget support or current costs of ‘reforms’. Shifting towards the finance of investment in growth-generating assets would make a substantial contribution to improving ODA performance.

Table 7: Recipient uses of ODA by Major Agency, OECD Estimates

<u>Expenditure Categories</u>	<u>Bilateral</u>	<u>EC</u>	<u>WB</u>
Current expenditure	83.7	75.9	62.7
Education	8.0	4.4	8.6
Health & related	15.4	4.0	16.8
Govt&civil society	12.2	13.9	12.4
Economic sectors	6.5	6.3	14.8
Debt relief	9.7	0.5	0.0
Humanitarian	7.7	7.8	0.0
Other	24.2	39.0	10.1
Capital expenditure	16.3	24.1	37.3

Source: http://www.oecd.org/document/9/0,3343,en_2649_34447_1893129_1_1_1_1,00.html

Fiscal Strategy for Development

For the least developed countries an investment-led strategy for poverty reduction could simultaneously provide a fiscal stimulus through increasing public investment. While such fiscal expansion might generate government deficits, there is no longer a consensus that these are necessarily inflationary. When inflation is kept within a moderate range, it does not necessarily dampen growth or directly harm the poor. Moreover, growth stimulated by fiscal expansion can generate the fiscal revenue needed to reduce budget deficits via the elasticity of taxes with respect to GDP.

Public investment is the necessary ingredient in a pro-poor development framework, serving four benign purposes: demand management, capacity creation, employment generation and income redistribution. In the absence of a robust public investment programme, the pro-poor element in fiscal policy is limited to counter-cyclical interventions, progressive taxation, and redistributive expenditure, all from the current budget. While each of these is important, they do not create sustainable

employment, and in least developed countries the capacity to implement progressive taxation and redistribution is limited. The progressiveness of the tax systems is typically constrained 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.

Perhaps most important, basing a redistribution strategy on the current budget is not a growth or employment generating 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 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.

7. Empowering National Policy in LDCs

The low level of development of financial institutions renders monetary policy ineffective in the least developed countries. Common currency arrangements further limit the policy options of many governments. In some countries policy options are limited by size of the fiscal deficit, current account imbalance, foreign exchange reserves and inflation. However, as the Freetown Declaration of African finance ministers stated, these constraints limit but do not preclude purposeful policy in which governments of least developed countries can assert themselves as agents of short term recovery and long term development. For a few governments active policy intervention can be done through a balance of all the standard instruments, fiscal, monetary and exchange rate. For a majority fiscal policy with domestic deficit financing can be used to re-commission the public sector as an agent of change. In three-quarters of the countries purposeful action is consistent with macro stability.

Governments need donors and the IMF to grant “policy space” through the following measures, specified in the Freetown Declaration:

- 1) elimination of the pro-cyclical conditionalities and “benchmarks” for deficit limits, inflation rates, external borrowing and foreign exchange holdings (all explicit in the Declaration);
- 2) donor reliability on delivery of assistance because the stimulus policies will be “finely tuned” and late or non-delivery of assistance could provoke macroeconomic instability; and, more generally,
- 3) a suspension of the “business as usual” approach to negotiations over development assistance which emphasizes “reform” issues that the external crisis has rendered of less immediate importance.

Along with these policy reforms, donors and lenders should fulfil their commitments to increase development assistance. By no reasonable measure is the level of assistance to LDCs excessive, and it appears that recovery of the developed countries began in late 2009, which will reduce fiscal deficits. The increased assistance should be provided in a manner that empowers the policy making ability of recipient governments, for example through an “aid fund” proposed in Section 4.

Annex 1: Development assistance Flows to Least Developed Countries,
OECD, 2002-2008

Annex Table 1: Development Assistance in millions of current US Dollars, 2002-2008

<u>Recipient</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Coef of var</u>
Afghanistan	986	1200	1701	2166	2405	2993	3951	47
Angola	286	372	1016	248	-55	86	184	112
Bangladesh	521	695	633	548	456	664	814	19
Benin	140	196	210	208	228	238	303	23
Bhutan	43	52	53	57	51	43	49	10
Burkina Faso	230	266	331	338	386	412	475	24
Burundi	85	121	186	180	222	200	255	33
Cambodia	273	319	297	346	348	417	425	17
Central African Rep.	40	32	55	60	65	118	129	52
Chad	67	96	163	162	153	223	277	44
Comoros	11	11	14	15	20	20	21	26
Congo, Dem. Rep.	351	5009	1165	990	1500	788	944	102
Djibouti	37	37	39	54	89	75	66	37
Equatorial Guinea	14	18	23	30	19	26	24	25
Eritrea	121	185	177	226	63	45	53	59
Ethiopia	489	1033	1025	1184	1024	1242	1839	36
Gambia	18	20	12	15	25	33	28	36
Guinea	126	135	178	126	103	122	209	26
Guinea-Bissau	26	98	29	27	39	44	53	56
Haiti	125	153	209	284	363	434	556	52
Kiribati	19	13	10	21	20	22	20	26
Laos	178	189	176	159	188	222	214	178
Lesotho	30	33	35	40	38	62	66	33
Liberia	27	70	163	144	187	226	809	113
Madagascar	126	225	685	498	261	387	274	54
Malawi	225	309	308	325	398	401	432	21
Maldives	13	9	9	40	16	18	20	60
Mali	257	272	328	371	398	558	531	31
Mauritania	147	136	83	105	94	133	139	21
Mozambique	1661	697	731	760	938	1073	1340	35
Myanmar	79	83	82	78	92	129	417	91
Nepal	279	320	318	345	318	377	451	16
Niger	114	245	306	254	235	233	269	25
Rwanda	199	213	217	281	321	374	450	32
Sao Tome & Principe	19	25	22	18	18	31	26	21
Senegal	243	314	755	444	509	451	544	36
Sierra Leone	225	208	163	129	180	381	175	39
Solomon Islands	21	56	117	172	179	237	219	57
Somalia	102	114	140	145	263	257	565	72
Sudan	232	332	848	1455	1517	1664	1818	58
Tanzania	909	966	1029	858	992	1831	1366	31
Timor-Leste	187	147	141	160	174	226	228	20
Togo	39	46	52	59	55	65	176	67
Tuvalu	11	5	5	6	13	9	15	11
Uganda	466	587	684	691	938	1002	1005	28
Vanuatu	22	28	35	33	41	52	89	52
Yemen	119	127	153	133	135	167	207	20
Zambia	<u>360</u>	<u>592</u>	<u>746</u>	<u>823</u>	<u>1115</u>	<u>713</u>	<u>703</u>	32
Total	10108	16217	15674	15647	16938	19294	22995	

Source: http://www.oecd.org/departement/0,2688,en_2649_33721_1_1_1_1_1,00.html

Annex Table 2: Development Assistance in millions of constant US Dollars, 2002-2008

<u>Recipient</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Afghanistan	1393	1458	1906	2363	2540	2993	3823
Angola	397	454	1196	274	-67	86	173
Bangladesh	726	877	740	631	504	664	800
Benin	209	249	241	231	251	238	281
Bhutan	58	62	59	61	54	43	44
Burkina Faso	352	340	385	382	424	412	442
Burundi	127	153	217	203	241	200	240
Cambodia	361	368	324	370	369	417	400
Central African Rep.	55	42	64	68	71	118	121
Chad	102	122	186	179	165	223	263
Comoros	18	15	16	17	22	20	19
Congo, Dem. Rep.	524	6309	1346	1041	1596	788	915
Djibouti	55	45	44	60	98	75	61
Equatorial Guinea	23	24	28	35	21	26	22
Eritrea	172	227	205	246	68	45	49
Ethiopia	683	1242	1172	1304	1104	1242	1790
Gambia	22	22	13	16	26	33	27
Guinea	168	162	202	138	109	122	195
Guinea-Bissau	40	128	34	31	44	44	48
Haiti	165	184	243	317	385	434	534
Kiribati	26	17	12	22	21	22	19
Laos	229	217	188	170	201	222	198
Lesotho	42	41	41	44	42	62	63
Liberia	36	89	185	158	198	226	771
Madagascar	178	285	799	561	280	387	258
Malawi	319	394	359	369	435	401	426
Maldives	16	10	9	40	17	18	18
Mali	377	344	383	417	433	558	499
Mauritania	224	167	94	116	102	133	129
Mozambique	2557	891	857	868	1020	1073	1287
Myanmar	96	95	90	84	98	129	404
Nepal	369	394	358	378	342	377	434
Niger	167	314	355	285	257	233	252
Rwanda	293	273	252	319	349	374	438
Sao Tome & Principe	31	33	25	21	20	31	24
Senegal	352	399	876	504	560	451	510
Sierra Leone	325	263	189	147	192	381	176
Solomon Islands	41	96	148	201	204	237	211
Somalia	152	151	168	165	285	257	547
Sudan	318	409	978	1611	1619	1664	1758
Tanzania	1376	1246	1197	974	1087	1831	1317
Timor-Leste	299	196	167	177	191	226	215
Togo	59	59	62	67	61	65	165
Tuvalu	14	7	7	7	13	9	14
Uganda	690	747	790	772	1020	1002	961
Vanuatu	37	40	42	38	47	52	85
Yemen	174	152	169	148	146	167	198
Zambia	513	755	876	909	1210	713	674
Total	14718	20341	18102	17364	18263	19294	22090

Source: http://www.oecd.org/departement/0,2688,en_2649_33721_1_1_1_1_1,00.html

Annex 2: Analytical Framework for Assessing Macro Conditionality

3.1 Countercyclical Algebra

For success a countercyclical policy package must be consistent with a sustainable balance of payments and manageable inflation. Achieving the appropriate balance requires careful use of available policy instruments. As shown in the text above, in all least developed countries monetary policy is not effective except to accommodate fiscal policy. This reduces the stimulus tools to policy and exchange rate management. With underutilized resources both measures should stimulate output. This annex considers the algebra of a stimulus package for countries in which both instruments can be used and the consequence of typical IMF conditionalities.

Both devaluation and fiscal expansion have potentially negative effects that require careful management. Since the income elasticity of taxes is typically less than unity in least developed countries, increasing government expenditure will always increase the fiscal deficit relatively to national income. Simultaneously there would be an increased and possibly unsustainable trade deficit. The policy goal is to prevent the latter through devaluation, which has its own problem, the inflation it generates.

Identifying the appropriate balance between increased expenditure and devaluation is facilitated by use of algebra. The rate of growth of the real demand for output (y) for a time period can be specified as the weighted sum of the growth of autonomous expenditures times the multiplier:

$$y = \beta[a_1i + a_2g + a_3x - a_4z], \quad \sum a_i = 1$$

The lower case letters i , g , x and z are the rates of change of expenditures that are exogenous with respect to national income, including the exchange-rate-induced components of trade (private investment, government expenditure, exports, and imports, respectively). The a_i terms are the shares in national income of each variable and β is the multiplier. Exports have an autonomous component whose rate of change is x^0 , and a component determined by the real exchange rate. Imports are a function of national income and the real exchange rate. Define ϵ_x and ϵ_z as the elasticities of exports and imports with respect to the real exchange rate, p as the price level and δ the marginal propensity to import:

$$x = x^0 + \epsilon_x e^*$$

$$z = \delta y - \epsilon_Z e^*$$

The change in the real exchange rate (e^*) is the change in the nominal rate (e) minus the rate of inflation (p). The *ceteris paribus* rate of inflation is the pass-through rate of a devaluation (the marginal propensity to import, δ).

$$e^* = e - p = e - \delta e = (1 - \delta)e$$

$$x = x^0 + \epsilon_X(1 - \delta)e$$

$$z = \delta y - \epsilon_Z(1 - \delta)e$$

These can be substituted into the growth of demand equation. We interpret x^0 as an external shock to export demand, and assume that it causes depressed expectations that render the growth of private investment zero. Assume that the government seeks to prevent national income from falling ($y = 0$). To simplify, write a_3/a_2 as α and define $(\epsilon_X + \epsilon_Y) = \epsilon_T$. If the trade elasticities are positive, ($\epsilon_T > 0$), a real devaluation improves the trade balance (Marshall-Lerner condition).³⁵ For zero growth, the real demand equation is:

$$0 = a_2 g + a_3 x^0 + a_3 \epsilon_T (1 - \delta)e$$

For any shock to exports (x^0) the relationship between the change in expenditure and the devaluation is determined by three parameters, the ratio of exports to government expenditure, the real exchange rate elasticity of trade, and the propensity to import. If the exchange rate is constant, the government expenditure that stabilizes output is:

$$g = \alpha x^0$$

For no increase in government expenditure, stabilizing output requires the nominal devaluation to be:

$$e = x^0 / [\epsilon_T (1 - \delta)]$$

The relationship between e and g for zero growth is shown in the upper right quadrant of Figure A1. The upper left quadrant relates the nominal exchange rate to its inflationary effect (e and p), and the lower left quadrant links the change in the real exchange rate to the trade deficit (e^* and $X-Z$).³⁶ An export shock decreases national income and increases the trade

³⁵ The more familiar condition of greater than unity refers to the nominal exchange rate and export and import values.

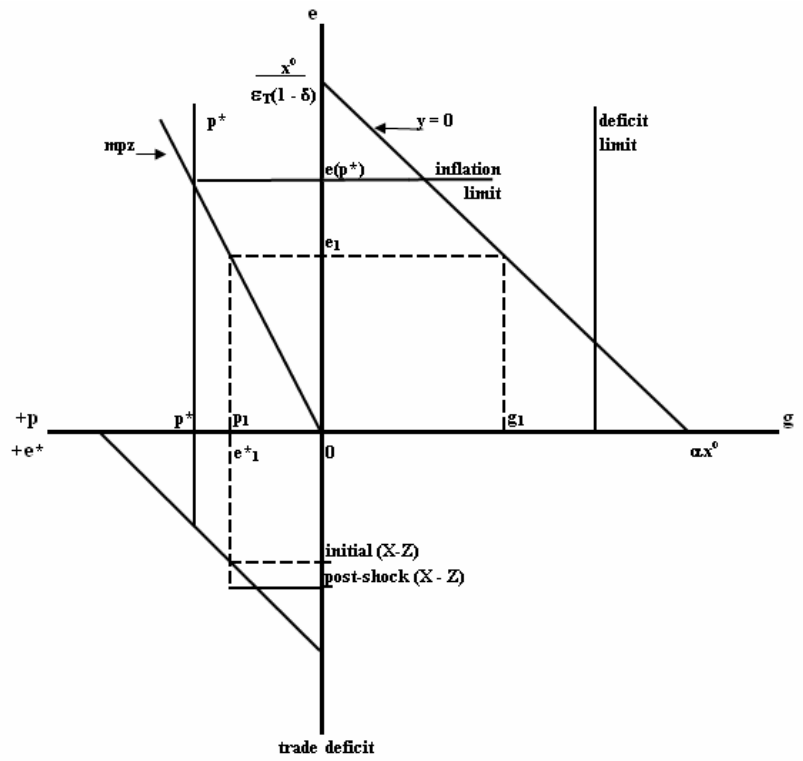
³⁶ Figure 1 is a simplified presentation. It does not include the effect of changes in national income on import demand.

deficit. We assume that the government must return to the initial trade deficit within one time period or suffer an unsustainable loss of reserves. Regaining the initial trade deficit requires a real devaluation of e^*_1 , which implies a nominal devaluation of e_1 . This sets the lower limit of the devaluation, which defines a feasible range for the increase of government expenditure to prevent a fall in output ($g > g_1$).

Two other goals of the government constrain policy, inflation and deficit limits. In Figure A1 in the upper right quadrant there is a feasible policy range, below the “inflation limit” and above the “deficit limit”. If the acceptable inflation rate is below p_1 , then no combination of devaluation and increased expenditure is consistent with restoring the trade balance and stabilizing output in the short run, though it would be possible with a series of devaluations in the medium term. This demonstrates the necessity for exchange rate management. Leaving the currency to float when expenditure increases can result in excessive inflation as the depreciation seeks balance of trade sustainability. If the limit for the fiscal deficit were below what would be generated by expenditure increase g_1 , there might remain a feasible short term region involving a low expenditure increase and a large devaluation.

If at the initial conditions the fiscal deficit is close to that set by donor and lender conditionality and/or the inflation rate is near its conditionality limit, the government has no space for a policy response to the export shock. It is this policy constrained situation that the Freetown Declaration sought to avoid by requesting more policy space from the IMF and other donors and lenders.

Figure 1: Policy Options for countercyclical intervention



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Giovanni Valensisi

First, we appreciated a lot the critique of the current ODA framework in LDCs (section 4 of your paper), and we believe it is very topical and represents a key contribution for the report.

To place it even more in its context, it could be helpful to refer also to the existing debate on aid efficiency, and refer to specific examples of donor-conditionality that prevented LDCs from carrying out counter-cyclical and/or developmental policies.

JW Comment: an example is given on page 40. Analytical discussion is found in the new Annex 2.

Secondly, the paper provides a thorough treatment of the rationale for counter-cyclical policies in LDCs and an interesting analysis of the constraints faced in that respect. In addition to the present analysis, and in line the original outline (attached here for your reference), the paper may benefit from a clearer distinction between short-term versus long-term development challenges, and a better coverage of the latter. Our suggestion in this respect would be to concentrate Section 5 on counter-cyclical policies and devote Section 6 to long-term developmental policies, along the same line of the presentation you provided in the Expert Meeting of the 23-24 February.

JW comment: New section 6 on long term growth promotion has been added.

Finally, we would be grateful if you could send, along with the final draft, also the spreadsheets and data you generated. We request that to every consultant, not only to have the complete set of material, but also to be able to change the formats of graphs and charts as required for the final editing.

JW: This will be done.

DETAILED COMMENTS BY SECTION

Section 2

The critique of the orthodox macro-policy stance is compelling. In addition to the present analysis, it would be helpful to have an account of the failure of the policies sponsored by the IFIs not only to allow LDCs to pursue counter-cyclical interventions, but also to enable them to use developmental policies that improve their long term resilience to shocks, promoting structural change, local resource mobilization and productive capacity development.

JW Comment: I am unclear what is meant by “an account of the failure of the policies sponsored by the IFIs...” Please explain.

Section 3

1. The analysis of growth projections is well disaggregated and thorough, but it would be helpful to clarify a bit more the methodology employed to build them, and in particular how "regression-based adjustments" are obtained. In that respect, would it be possible to present the results of the regressions employed to do such adjustments in the appendix?

JW: this has been done at the end of the table and the SPSS files sent.

2. In tables 1 and 2 (as well as in charts 1 and 2) data for Laos, Samoa and Tuvalu are missing; to our knowledge WDI data should be problematic only for Tuvalu but not for the other 48 LDCs. In case there are other reasons to exclude Laos and Samoa, it would be useful to clarify them in the text?

JW: Laos is included. There are no data for Tuvalu and Samoa. See comments below.

Section 4

1. ODA data for Laos, Samoa and Tuvalu are not included in the analysis, but should be available from OECD DAC database (see <http://www.oecd.org/dataoecd/50/17/5037721.htm>); would it be possible to include these countries as well?

JW: There are no ODA statistics for Samoa (see accompanying OECD worksheet) and no GDP data for Samoa and Tuvalu. Laos now included.

2. It would be important to link the analysis of recent trends in ODA to LDCs with the existing literature on aid efficiency, while referring to some examples of where donor-conditionality prevented LDCs from pursuing counter-cyclical interventions.

JW: I am not an expert on aid efficiency. Indeed, I know almost nothing about it.

3. The discussion of the Aid Fund is crucial for the whole reasoning. In our view, the proposal would acquire an even greater strength if the paper could touch upon related political economy aspects such as: i) how to ensure that rent-seeking is avoided, and that funds are effectively used in a counter-cyclical way and not for vested interests; ii) how donors' coordination may be achieved to finance the Aid Fund, and iii) what incentive structure could improve domestic resource mobilization in recipient countries.

JW: These issues are beyond my expertise, though I do have views, one of which is that the term “rent-seeking” is an ideologically motivated analytical confusion. Donor coordination is a very specialised area about which I know almost nothing. If the final comment refers to taxation, I believe that it is analytically confused to link ODA and domestic revenue. Discuss of the Aid Fund has been considerably expanded in pp 16-19.

Section 5

1. The treatment of "bank squeezing out" and of macroeconomic constraints faced by LDCs is very insightful indeed. In addition to the present analysis, it would be very helpful to us if the discussion could be framed within the distinction between short-term measures aimed at economic recovery and long-term developmental policies (reflecting even more closely the original outline of the paper). Perhaps the easiest way to do so could be to concentrate on recovery-measures here, and elaborate the longer-term developmental policies in the next section.

JW: The new section 6 deals with long term growth.

2. Again, data for Laos, Samoa and Tuvalu are missing; would it be possible to include them as well?

JW: There are no ODA statistics for Samoa (see accompanying OECD worksheet) and no GDP data for Samoa and Tuvalu. Laos now included.

3. It would be useful if the notes for table 3 and 6 could mention the year to which indicators are referred, when different from 2006-2007.

JW: This has been done.

4. Tables 5 and 6 seem to contain some inconsistencies vis-à-vis table 3 (i.e. the total number of countries in table 5 is not 46).

JW: Tables are corrected.

5. It could be helpful to clarify in the text how table 6 and figure 11 are obtained, so as to make them more easily readable.

JW: This has been done.