

# **Pro-Poor Macroeconomic Policy: Lessons from the Asia-Pacific Region**

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## Preface

**Macroeconomic policies affect both the rate of growth of the economy and the distribution of the benefits of growth across economic sectors and social groups. The structural change and economic reforms that have been adopted in many Asian countries during the last two decades add new dimensions to the linkage between macroeconomic policies and poverty reduction. With these considerations as well as in the context of supporting the achievement of the Millennium Development Goals (MDG), UNDP Regional centre in Colombo has carried out a series of policy-oriented country case studies and thematic studies on the linkages between macroeconomic policies, growth and poverty reduction in the context of identifying and promoting more pro-poor macroeconomic policies in the region.**

**These country case studies covering Bangladesh, Bhutan, Cambodia, China, India, Indonesia, Iran, Lao PDR, Myanmar, Nepal, Pakistan, Samoa, Sri Lanka and Vietnam contain (i) a descriptive narrative of basic trends in economic aggregates, inequality and poverty, explicitly geared to the assessment of macro-level policies, (ii) a “policy audit”, namely, an assessment primarily of the impact on poverty of the macroeconomic and adjustment policies, and (iii) an elaboration of feasible policy alternatives that would be more effective in reducing poverty and inequality. Each of these country case studies was prepared by a team of international consultants, national consultants and UNDP advisors covering 6-8 macro policy issues such as fiscal policy, monetary policy, exchange rate, trade liberalisation, financial liberalisation, privatisation, etc. These case studies have already been presented and discussed at national and regional levels as well as published and disseminated widely.**

**The objective of this publication is to bring together the main findings of the above mentioned case studies which can serve as an important advocacy and dissemination tool. This synthesis report could not have been prepared without the generous contributions of many individuals and institutions. At the outset, I would like to express my appreciation to the author of this synthesis study as well as authors of the country case studies and thematic studies, focal points from UNDP country offices, UNDP Regional Centre in Colombo and UNOPS-Asia office for their support and diligence in preparing these studies. In particular, I would like to acknowledge Anuradha Seth, Senior Policy Advisor at RCC for taking the initiative to**

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**I hope that the independent views and professional competence of the authors ensure that the conclusions and recommendations will have the greatest possible audience in Asia and the Pacific and elsewhere.**

**Omar Noman  
Chief, Policies and Programme  
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## **Introduction**

The aim of this study is to bring together the main findings of the country case studies and thematic studies on the macroeconomics of poverty reduction undertaken by UNDP Regional Centre in Colombo during the last six years. Fifteen country case studies<sup>1</sup> and nine thematic studies on macroeconomics of poverty reduction were prepared.

These studies have produced a wealth of data on specific countries and valuable conclusions on macroeconomic policies' effects on poverty reduction which can helpfully frame and guide future discussions on macroeconomic policy choices in the region.

This paper reflects the perspectives and ideas presented by contributors, drawing on the overall conclusions of the country and thematic studies commissioned. However, the many capable scholars who contributed understandably came to different conclusions, or at least differing emphases, on some points. This paper aims to draw a set of common conclusions based on the country and thematic studies.

This paper addresses fiscal and monetary policy, exchange rate policy, international trade and investment policy, privatisation and management of public enterprises, and financial liberalisation. This paper also addresses important cross-cutting issues, emphasising the need to recognize that policy choices in seemingly distinct areas have consequences for the poor which depend on how they are combined, that the inter-temporal sequencing of policies has considerable implications, and that what complementary policies are adopted (including microeconomic interventions to ensure broad-based asset distribution and appropriate support for agriculture) can be crucial to ensuring that the policy framework as a whole is pro-poor.

For reasons of space, it has not been possible to refer in detail to individual country studies; footnotes refer the interested reader to country studies that illustrate specific points. Individuals interested in particular countries' experiences should consult the country studies directly for the wealth of information that they contain.

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<sup>1</sup> The countries studied were Bhutan, Bangladesh, Cambodia, China, India, Indonesia, Iran, Lao PDR, Mongolia, Myanmar, Nepal, Pakistan, Samoa, Sri Lanka, and Vietnam.

The policy lessons of these studies may be summarized as follows. First, there is ample evidence to support the view that the government has a vital role to play in poverty reduction. While nurturing the growth of private entrepreneurial and managerial capabilities, governments must develop their own capacities to act in order to protect the poor and not shy away from active policies and interventions where these may be required. A private-property centred market system cannot in isolation be expected to generate pro-poor growth.

Specifically, this means that governments:

- In fiscal policy, must adopt balanced taxation policies, spending where necessary to foster development or protect the poor. The overall combination of taxation and expenditure policies should be progressive.
- In monetary policy, must be guided in setting interest rates and money supply growth by the requirements of economic stabilization and development (recognizing the crucial developmental role of credit), rather than by arbitrary or imported inflation targets.
- In trade policy, should pursue gradual and managed integration with the world economy, instituting social safety nets to protect the population, especially the poor, from economic shocks associated with trade, whether of a one-time or an ongoing nature.
- In exchange rate policy, should select among different regimes including fixed, floating, or partially managed floats, depending on pragmatic considerations, recognizing the potential developmental importance of export competitiveness and the need to avoid the emergence of conditions in which speculative attacks will be attractive.
- In management of the external account, exercise caution in liberalization of the capital account and consider taxation of flows or quantitative measures where required to manage the inflow or outflow of potentially destabilizing portfolio investment flows
- In privatizing state-owned enterprises (SOEs), take account of revenue implications of privatization, construct effective standing safety nets to provide for workers who are likely to undergo periods of unemployment after privatization and ensure that appropriate regulatory regimes are in place to ensure adequate competition and efficient pricing in privatized industries.

## Lessons for Pro-Poor Macroeconomic Policy

### *The theory of the ‘second best’ as a framework for pro-poor policy*

In 1956, Lipsey and Lancaster set out the theory of the ‘second best’<sup>2</sup>, describing how, when the optimality conditions associated with a specific control variable fail to be attained in an economic model, the best policy response may be to change *other* variables to something other than those otherwise assumed to be optimal. The theory of the second best is particularly applicable to development policy where deviations from the abstract, ‘first best’ world of competitive market economies are common, yet governments are often urged by economists and international financial institutions to adopt policies that are deemed optimal on the basis of abstract ‘first best’ theorizing.

This framework has recently been used to good effect by Dani Rodrik in analyzing policies of economic growth. Rodrik and others have argued on the basis of empirical evidence that adopting the policies generally assumed to be the ‘first best’ can lead to sub-optimal results.<sup>3</sup> In such a context, experimental ‘search’ for the best policies or the use of ‘growth diagnostics’ (which attempts to identify where the constraints to growth are, and how these can best be overcome) become the central tools of development policy.<sup>4</sup>

From the standpoint of such a perspective, the most pro-poor macroeconomic policies must necessarily be discovered in a context-specific manner on the basis of appropriate experimentation, and through pragmatic observation and problem solving. It is against this background that the detailed conclusions laid out below for specific thematic areas are best understood.

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<sup>2</sup> R.G. Lipsey & Kelvin Lancaster, [The General Theory of Second Best](#), *The Review of Economic Studies*, Vol. 24, No. 1. (1956 - 1957), pp. 11-32.

<sup>3</sup> Margaret McMillan, Karen Horn, and Dani Rodrik, “When Economic Reform Goes Wrong: Cashews in Mozambique”, <http://ksghome.harvard.edu/~drodrik/nuts.pdf>.

<sup>4</sup> Francisco Rodríguez, “Policymakers Beware: The Use and Misuse of Regressions in Explaining Economic Growth” Policy research brief Nov/2007 no. 5, International Poverty Centre, and “Cleaning Up the Kitchen Sink: Growth Empirics When the World Is Not Simple”, Wesleyan Economic Working Papers, No: 2006-004, <http://repec.wesleyan.edu/>

## ***1. Fiscal and monetary policy***

We begin our more detailed enquiry into pro-poor macroeconomic policies by considering fiscal and monetary policies.

It has been widely argued in recent decades that fiscal conservatism is an essential requirement for creating a macroeconomic environment conducive to growth and stability. In particular, there has been a considerable emphasis on the maintenance of low budget deficits and inflation rates.

However, pro-poor policies must by definition not merely promote growth, but promote growth that benefits the poor. Such policies may include a supportive public investment programme and progressive tax and transfer systems. Countercyclical policies, although potentially important to achieving various goals, may not always be classifiable as pro-poor policies.<sup>5</sup>

Progressive taxation and expenditure are among the fiscal tools that can support poverty reduction, but in many developing countries their effective scope, and the capacity to implement them, are limited. The usefulness of a progressive tax system in particular is constrained by the administrative limitations of the tax system, which is often heavily reliant on relatively regressive indirect taxes, because of the few ‘tax handles’ available. For example, a country with a large agricultural sector or informal sector may find it difficult to monitor and thus to tax individual incomes arising from these sectors. In contrast, it may find it relatively easy to levy customs and excise duties or sales taxes on formal sector enterprises, which are more visible by virtue of being formal, and concentrated in urban centres.

Given the constraints on progressive taxation, a robust, pro-poor public investment programme *may* require contained deficit spending. The effects of such deficits must be considered in context. Governments that single-mindedly focus on deficit targets without considering growth or poverty objectives may risk stagnation. Contrastingly, deficit-financed public investment can be ultimately self-financing.

In recent decades, many countries in Asia and the Pacific implemented a series of tax reforms to mobilise domestic resources. Though these reforms indeed

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<sup>5</sup> Sanjay G. Reddy, “Safety Nets for the Poor: A Missing International Dimension?” in *Pro-Poor Macroeconomic Policies*, Giovanni Andrea Cornia, ed, New York: Palgrave Macmillan and UNRISD, 2006.

helped in raising tax-GDP ratios in some countries (such as Bangladesh, Bhutan, Lao PDR, and Vietnam) they have not helped in securing additional resources in many other countries (including China, India, Myanmar, Nepal, Pakistan, and Sri Lanka). As a result, some of these countries have been compelled to make major cutbacks in public expenditure in order to contain fiscal deficits. Of the two broad components of government expenditures- current and capital – it is the capital expenditure that has declined significantly in most of the countries studied. For example, in countries such as Pakistan and Sri Lanka, capital expenditure as a percentage of the GDP has fallen by almost a factor of one-half. It is likely that in such cases the trends in fiscal policy have exerted a negative influence on growth.<sup>6</sup>

The size of the fiscal deficit (as a percentage of the GDP) has fallen in most of the countries studied, with the exceptions of Cambodia, Lao PDR, and India. However, the path to fiscal adjustment has been achieved in different ways. Some countries such as Bangladesh have opted to use part of their revenue gains to bring down their fiscal deficit and the remaining part to raise the level of public expenditure. Some other countries like Vietnam have managed large increases in the revenue to GDP ratio, but have combined this with limits on public expenditure to achieve significant lowering of the fiscal deficit.<sup>7</sup>

Only in a few of the case study countries (Mongolia, Pakistan and Sri Lanka) was the deficit so large as to require its reduction to be a policy priority. The other countries satisfied the so-called golden rule of fiscal policy (that if governments cover current expenditures by current revenues, public investment can be responsibly financed by borrowing or through development assistance).

It is also interesting to note that countries such as India and Sri Lanka have been able to achieve relatively high rates of growth (in excess of 5 percent) despite carrying large fiscal deficits (above 5 percent of GDP) in the 1990s. In these countries, there is no clear evidence of a “crowding out” effect as the overall all rate of investment has gone up during the 1990s.

In Vietnam, fiscal deficits were high in the 1980s due to a relatively high level of public investment expenditure. This strategy was perhaps one of the contributing factors to the high economic growth, which enabled a rapid expansion of revenues and substantial containment of the fiscal deficit in the

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<sup>6</sup> Pasha and Palanivel, 2003, p. 329 and Palanivel, 2008 (mimeo)

<sup>7</sup> Ibid, p.329

second half of the 1990s, leading to a period characterised by macroeconomic stability and high growth. In contrast to this, Pakistan, possibly under pressure of the IFIs, undertook steep fiscal adjustment during 1990s, largely through cutbacks in total public expenditure (including capital expenditure). This may have been one of the reasons for the relatively slow growth of the Pakistani economy in the 1990s.

The relationship between deficits and inflation will be elaborated below in the discussion of monetary policy. In no country that was part of the study were policy alternatives found to be so limited that actively pro-poor fiscal policies were deemed infeasible.

### **The Importance of Public Investment-Led Growth**

Public investment is a crucial fiscal instrument for promoting growth and countering poverty. It serves three important objectives: the expansion of productive capability, the management of effective demand, and furthering distributive goals.

Public investment can create assets that foster earning opportunities for the poor. These may include public works and schemes that aim to create employment or distribute productive assets, and schemes that may not target the poor specifically but that help to raise the wages of the poor by contributing to labour market demand or setting wage floors.

Public investment may include the creation of infrastructure and social sector assets. For example, improved transportation infrastructure can give the poor increased access to markets and lower production costs of informal and small-scale enterprises. Investment in schools and health clinics ultimately increases the productivity of the poor, and can enhance their ability effectively to participate in the political system.

The case for public sector investment must address the criticism that it crowds out private investment.

In the Asia-Pacific region, rising government expenditure does not appear to have had crowding-out effects, for private investment grew faster than public investment in the 1990s. In many countries of the region buoyant private investment has gone hand in hand with major increases in public investment.

Examples of this complementary relationship are seen in China and Vietnam. Some evidence points to ‘crowding in’ through a multiplier effect and the impact of profit expectations and cost reductions associated with improved infrastructure. Countries that have limited the investment role of the public sector such as, Cambodia, Indonesia, Nepal, and Pakistan have experienced an inferior investment performance by the private sector.<sup>8</sup> Indonesia is a particularly clear case in which low public investment has been associated with weak private sector performance.

The country studies are uniform in emphasizing public sector investment’s often positive effects. The studies assert that, to varying degrees in each country and sector, the net effect of public investment is to *attract* private investment through the ‘multiplier effect’ on effective demand, by enhancing profit expectations, and by reducing costs of enterprises through improved infrastructure. It is suggested that there are strong ‘second best’ arguments for public investment, as it can help to counter the effects of poor financial intermediation, supply side bottlenecks and/or demand side constraints.<sup>9</sup>

Increasing public-sector investment need not imply increasing overall public expenditure. Pro-poor fiscal analysis has often focused on expenditure-switching policies which reallocate funds. Inter-temporal tradeoffs must play a role in assessing whether expenditure switching is pro-poor. Although increases in social expenditure are often pro-poor, shifts in spending away from ‘economic’ investments (such as public infrastructure) may reduce the long-term growth potential of the country which can have detrimental effects on the poor in the intermediate and long run.

### **Fiscal Policy for pro-poor development**

Effective pro-poor fiscal policy in most cases permits counter-cyclical intervention, public investment, and a balanced expenditure pattern (encompassing appropriate growth-enhancing economic investments and poverty-reducing social investments).

The ability to undertake such policies in turn presupposes the availability of adequate ‘fiscal space’, broadly defined as a government’s ability to undertake

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<sup>8</sup> Pasha and Palanivel, 2003, Ibid, P.331

<sup>9</sup> Ricardo Hausman, Dani Rodrik and Andrés Velasco (2004). ‘Growth Diagnostics’. mimeo, Harvard University.

adequate levels of effective expenditures in a sustainable manner. In turn this implies, inter alia, the ability to raise adequate taxes and to borrow at reasonable costs.<sup>10</sup>

Governments should pursue improvements to tax regimes but note the risks involved in the implementation of systematic reforms. It has been very popular in recent years to argue for a Value Added Tax (VAT), in place of taxes on international trade and specific sales and excise taxes, in order to diminish both cross-border and inter-sectoral distortions. However, the introduction of the VAT may not be a ‘revenue-neutral’ action, and this can carry substantial implications. Where the informal sector is large, the VAT applies only to a fraction of economic activity. Its introduction in place of other indirect taxes can therefore create revenue shortfalls. Moreover, in such conditions the introduction of the VAT creates a distortion in favour of production in formal sector enterprises, which are eligible to claim tax rebates for which informal sector enterprises are ineligible.<sup>11</sup>

Notwithstanding efforts to mobilize domestic resources through appropriate tax regimes, developing countries are likely to be financially constrained. However, a developmentally-oriented fiscal policy may require some deficit spending in order to finance investments that possess a ‘development payback’. While sustained borrowing to finance consumption is unsustainable, borrowing to finance productive investment need not threaten macroeconomic stability, and in particular need not necessarily be inflationary, as will be discussed below. The objections to increased public spending are rooted in an ideology that would sharply restrict the role of the government. Our disagreement with this position has been earlier expressed.

### **Monetary Policy for pro-poor development?**

During the 1990s monetary policy has tended to be less expansionary in the majority of the countries studied. The rate of expansion in money supply has been generally lower or similar to that during the 1990s, with the notable exceptions of Pakistan and Sri Lanka. Consequently, real interest rates were

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<sup>10</sup> Rathin Roy, Antoine Heuty, and Emmanuel Letouzé. “Fiscal Space for Public Investment: Towards a Human Development Approach”. Paper prepared for the G-24 technical meeting, Singapore, September 13-14, 2006

<sup>11</sup> The Samoa country study praises the VAT as contributing substantially to growth of revenue. In India, certain governments have inaugurated VAT. Of the other countries that we have studied for (Iran, Sri Lanka, Bhutan) none has VAT.

relatively high in the 1990s, and have fallen only in the recent years. The tightening of monetary policy throughout the region appears to have been largely motivated by the objective of containing inflation. It is, therefore not surprising that inflation rates have been lower in the majority of countries studied in the 1990s. A few countries such as Indonesia and Pakistan have experienced higher inflation, arising in the latter case from the pressure exerted on the money supply by runaway government borrowing in the first half of the 1990s. In the case of Indonesia, inflation spiralled in the aftermath of the East Asian financial crisis.<sup>12</sup>

The case studies indicate that the correlation between increases in the monetary supply and inflation was loose, perhaps reflecting excess demand for money due to financial deepening. Some of the studies also cast doubt on the validity of the causal link between (broad) money stock and inflation. Inflation in Asia and the Pacific seems considerably to be influenced by cost push factors. The case studies raise concerns about possible overemphasis on low inflation targets and their possible adverse effects on economic recovery. This point is highlighted by the following select quotations from the country reports:

While lower inflation...is a positive indicator...a near-zero inflation rate may be symptomatic of demand deficiency leading to capacity underutilization...Targeting for a too-low inflation rate...can sometimes result in overkill. Production contraction can happen if prices are not flexible downward, which may be the case not only for industrial production, but also for many subsistence-type activities where the price...may be determined somewhat inflexibly like the so called subsistence wage...Yet another problem with pushing inflation too low is that it will make it difficult to bring about the large relative price changes that the structural adjustment policies aim at. (Bangladesh study, p. 38).

The point is not that the authority has to fight inflation at any price .... Rather, it has to face the tough question of how far to go with fighting inflation, knowing that with ongoing deflation an economy might face greater risk of entering into the chain of rising unemployment, falling demand, and reduction in the level of national income...This restricted policy should not be seen as the only way out, without flexibility. The inflation rate...has remained low since 1995. We can even say that it is too low, showing a deflationary trend throughout the period from mid 1999 to 2001...Different studies provide that the threshold inflation for developing countries that maximize output is about 10 percent to 15 percent. Indeed a double-digit inflation like 15 percent might not be good for Cambodia...But, the targeted inflation of about 4 percent...seems to be low if the aim is to create employment and economic growth. (Cambodia study, pp. 48, 60-61).

In the current context, one of China's important challenges appears to lie in counteracting deflationary pressures and sustaining rapid economic growth rather than combating inflation...Persistent deflation may have serious adverse effects on China's economic growth and poverty reduction prospects. (China study, p. 72).

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<sup>12</sup> Pasha and Palanivel, 2003, Ibid, P.331

Policymakers continue to adhere to tight IMF-prescribed fiscal and monetary targets in order to achieve single-digit inflation rates...Meanwhile, domestic consumption, not private investment, is supporting growth. But clearly this is not sustainable...High interest rates [needed for a low inflation target] are an impediment to growth in circumstances such as Indonesia's, where the corporate sector is heavily indebted. (Indonesia study, pp. 15, 19)

These concerns are not unfounded. All country reports recommend an expansionary monetary policy to facilitate fiscal stimulus, enhance investment and foster Small and Medium Enterprise (SME) growth. The Bangladesh report states that macroeconomic policy should aim at softening physical infrastructure and access to credit constraints (p. 33). The China report (p. 78) concludes, "In line with 'pro-poor' monetary policy approach, additional money supply could be used more actively to support small and medium sized financial institutions, which may be more suitable ... in addressing the credit needs of the private sector and small and medium-sized enterprises. Also, the central bank could increase its lending support to the development of rural cooperative financial organizations," (p. 78). Similarly, the Indonesia report highlights the need for economic policies to foster agricultural and SME growth since the majority of poor livelihoods are tied to agriculture, and SMEs possess potential to generate employment for the poor. It also recommends measures to improve SME access to the capital market. The Cambodia report provides detailed empirical evidence to refute the argument that an expansionary monetary-fiscal policy mix is necessarily inflationary. It argues that in Cambodia underemployment is endemic, while land generally remains underutilized. It asserts that the industrial sector operates below capacity and the country suffers from poor infrastructure, giving rise to conditions in which public investment does not crowd out private investment.

Poor countries are typically revenue-constrained. A robust programme of public investment can entail fiscal deficits and thus raise the spectre of inflation.

A conventional view is that poor countries should aim for monetary stability above all, maintaining low inflation—usually defined in the single digits—through avoidance of deficit spending accompanied by high interest rates if necessary, and a tight money supply. This view is believed by its supporters to be favourable to the poor, who, it is assumed, are hurt by inflation that will erode the value of their incomes, and to impede economic growth overall, which is thought to be aided by stable price expectations.

It is widely agreed that hyperinflation harms the poor by eroding the value of their incomes. However, the studies suggest that moderate inflation may not

hurt the poor as much as often believed, and in specific cases may even benefit them, for at least two reasons.

First, strategies for reducing inflation which restrict aggregate demand and output may diminish employment. This consequence of anti-inflationary policies may be more salient for the poor than the real wage increasing effect of reduced inflation. Second, inflation can benefit the poor by reducing the real value of their debts. This having been said, it is essential to be attentive to the consequences of inflation for the real incomes of the poor in specific country contexts, as these may differ a great deal depending on structural parameters such as the level of monetization of the economy, the extent to which the poor have access to 'inflation hedges' and whether 'core' inflation of essential items is affected differently by monetary expansion than are other components of inflation.

What is the relationship between moderate inflation on the one hand and economic growth and employment on the other? All of the country reports recommend an expansionary monetary policy to facilitate fiscal stimulus. There is no robust empirical basis for the fear that a *moderately* expansionary monetary policy must necessarily lead to high inflation. Joseph Stiglitz has noted that "There is simply little or no empirical evidence that inflation, at the low to moderate rates that have prevailed in recent decades, has any significant harmful real effects on output, employment, growth, or the distribution of income"<sup>13</sup> Dornbush and Fischer have argued, complementarily, that the cost of bringing inflation down from moderate to single-digit inflation can be quite high.<sup>14</sup> Indeed, a country may benefit from expansionary monetary policy even at the cost of moderate inflation, because of the fillip it provides to investment, especially (although not only) when there is excess capacity and persistently high unemployment or underemployment.

An important basis for the criticism of even moderate inflation is that it has a tendency to become ever higher, ultimately resulting in hyperinflation with its attendant economic and social costs. However, this fear is not adequately borne out empirically. At inflation rates below 40% per annum, there is a weak correlation between the rate of inflation and the likelihood of subsequent

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<sup>13</sup> Joseph Stiglitz, "The Phelps factor",

[http://commentisfree.guardian.co.uk/joseph\\_stiglitz/2006/12/the\\_phelps\\_factor.html](http://commentisfree.guardian.co.uk/joseph_stiglitz/2006/12/the_phelps_factor.html)

<sup>14</sup> Rudiger Dornbusch and Stanley Fischer, "Moderate Inflation", *The World Bank Economic Review*, Vol. 7, No. 1, pp. 1-44 (January 1993,

hyperinflation. A fixation on bringing about low single-digit inflation cannot be justified by fear of subsequent inflation.

There appear to be strong pro-poor arguments in favour of a moderately expansionary monetary policy over the intermediate and long term. Moreover, in the face of adverse shocks—whether of supply or demand—monetary policy may play an important role in stabilizing output.

Monetary policy is a key tool for managing demand shocks. Because the export base of many developing countries is very narrow they may be especially subject to such external shocks, which have knock-on effects on domestic consumption and investment. Monetary policy can help to counter-balance the effects of demand shocks. Demand shocks cannot be absorbed by exchange rate adjustments, which attempt to mitigate reductions in export demand through price reducing measures. In the case of many developing countries, the Marshall-Lerner elasticity condition for such depreciation to be revenue enhancing may not be met. This leaves monetary policy as a vital policy tool.

Supply shocks are arguably more common in developing countries than demand shocks, and in these cases as well, monetary policy is needed to stabilize employment for the poor, accepting moderate inflation as a trade-off where necessary.

An orthodox view is that central banks should have both ‘goal’ and ‘instrument’ independence so that it may pursue monetary stability credibly, without being unduly influenced by the government’s fiscal policy objectives. However, such independence can be counter-productive from the standpoint of the objectives of pro-poor macroeconomic policy. Banks with both goal and instrument independence, staffed with ‘inflation hawks’ (as explicitly recommended in the literature in favour of central bank independence) may choose very low inflation targets that have an adverse impact on employment and growth objectives. A better policy in many instances may be to give the central bank instrument autonomy but to have its goals guided by the overall economic objectives implied by the poverty reduction strategy of the government.

## ***2. Exchange Rate Policy***

In the last two decades, most developing countries have changed their exchange rate regimes in major ways, often in response to conditionalities applied by the Bretton Woods institutions or as part of their implementation of open economy

policies. The overall direction of the regime changes has been towards greater flexibility of exchange rates, accompanied by what has often been considered a complementary policy, liberalisation of capital accounts.

In the studied countries, no pattern emerges in the relationship between exchange rate regimes and macroeconomic performance. Movements in nominal exchange rates corresponded roughly with inflation in several countries, permitting us tentatively to conclude that by allowing nominal depreciation in the face of inflation, most countries could maintain their competitiveness.

It can be difficult to evaluate the effects of different types of exchange rate policies on macroeconomic outcomes for various reasons, including the following:

First, there can be major discrepancies between how countries classify their exchange regime, and how they operate in reality: for example, what is reported as a flexible exchange rate regime is often pegged in practice.<sup>15</sup> Second, the effectiveness of exchange rate policies cannot be determined in isolation. The effects of exchange rate policy are dependent on the fiscal and monetary policies pursued. Third, there is a problem of ‘endogeneity’ or ‘reverse causation’: just as exchange rate regimes influence macroeconomic outcomes, the choice of regime can be determined by macro conditions.

### **Exchange Rate Goals for the Poor: Stability and long-term undervaluation?**

Taking poverty reduction as the goal, which policies are most important?

First, exchange rate policy cannot be discussed in a vacuum; it must be closely coordinated with monetary policy. Avoiding currency crises is an important goal, since, as seen so dramatically in the Asian financial crises of the late 1990s, such crises can push millions of people below the poverty line more far more rapidly than growth can lift them above it.

Currency crises are generally believed to be the outcome of inconsistencies between fixed exchange rates and macroeconomic policies that result in balance of payments crises. Pegging a currency makes it vulnerable to currency crises when the peg becomes unsustainable. These inconsistencies are less likely to occur in dramatic form when the exchange rate is allowed to adjust smoothly,

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<sup>15</sup> Edwards and Savastano, “Exchange Rate Policies” (2002), cited in thematic paper on exchange rate policy.

suggesting that a flexible exchange rate may be desirable from a pro-poor perspective.

Where governments have control over exchange rates, they may employ devaluation to reduce the risk of balance of payments crises. Devaluation can enhance international competitiveness and boost export demand. However, devaluation can cause both inflation and economic contraction by reducing the overall demand for domestic goods. In highly indebted countries it will raise the domestic cost of meeting the external debt-servicing burden. Devaluation may also affect income distribution if it by lowering real wages (through its effect on the cost of imported wage goods) and thereby enhancing profits.

Whether government control over exchange rates provides an effective tool will depend on the nature of the crisis. For instance, as mentioned, devaluation of a currency may not help in a balance of payments crisis, but only cause stagflation. In such a situation, an expansionary monetary policy can complement exchange rate policy. The best course is, generally, for governments not to delay exchange rate adjustments. When currency valuation appears to be high enough to threaten a balance-of-payment crisis, governments should initiate an orderly downward adjustment, so as not to lose competitiveness and to avoid a disruptive economic crisis.

Yet even a coordinated exchange rate and monetary policy is insufficient: a country faces the prospect of recession following a sudden devaluation regardless of its monetary policy if its capital account is fully open and the devaluation is perceived as revealing a willingness to undertake future devaluations. Whether devaluations encourage inward FDI and portfolio investment depend in part on their effect on such expectations. Even in the absence of a crisis, many less developed countries do not have an adequate institutional and legal framework to handle capital flows nor are they attractive for such flows. Thus, capital account opening in many cases increases capital outflows, rather than inflows. To counterbalance this tendency, countries may have to have high domestic interest rates that adversely affect domestic investment, especially in SMEs. Under a flexible exchange rate, high interest rates can spur demand for domestic currency leading to nominal appreciation and loss of competitiveness. Under a fixed exchange rate system, accumulation of foreign currency by the central bank will cause monetary expansion and inflation, if inflows of foreign exchange are not fully sterilized (which may be unavoidable due to limits to such a strategy). In either case there will be real appreciation.

Capital inflows, although desirable, are not costless; managing capital flows can absorb significant government resources that could have been used for pro-poor programmes. Also, the prospect of capital flight can restrict a country's ability to use fiscal and monetary policies to address investment in infrastructure, priority sector development and human development.

Government's ability to pursue expansionary macroeconomic policies to counter the contraction effects of devaluation can be limited in the presence of capital mobility. A country may need to impose some control on short-term capital mobility to gain control over monetary and fiscal policies, because any intervention the government can make can be dwarfed by the effects of massive capital outflows. A sound approach may be to institute some capital controls (targeting short-term portfolio capital and not long-term FDI) until stability returns, to enable the government to pursue an expansionary policy to counter the contraction effect of devaluation.

Given the vulnerability of pegged currencies to crises, and the lack of perfectly effective policies to counter these crises, is a flexible exchange rate not preferable? Perhaps not: flexible exchange rate regimes are characterized by marked increases in volatility. It is sometimes thought that these increases in volatility can adversely affect exports by increasing transaction costs or adversely affect FDI, but there is mixed evidence in this connection.

Stability of the exchange rate does not in itself constitute a pro-poor policy. It must be help to support the goal of long-term growth. If we take as given that manufacturing export-led growth is an important tool for lifting people out of poverty, a somewhat undervalued currency (from the perspective of balance of payments equilibrium) may be desirable in the long-term.

Achieving the twin goals of short-term stability and long-term undervaluation of the exchange rate may require active management. A more flexible exchange rate is not, in itself, likely to be optimal for a developing country, as it may provide inadequate support for export competitiveness, but in general, neither is a hard peg, which is desirable from the standpoint of short-term stability but often unsustainable in the long-term. A recipe for pro-poor growth stability would seem to be some, but not too much, exchange rate flexibility, coordination of exchange rate management with monetary policy, and the application of controls on short-term capital flows in specific instances. Is this, however, a feasible combination?

## Policy objectives and Options

The famous trilemma of exchange rate policy is that a country cannot simultaneously pursue goals of international financial integration, monetary independence and control of the exchange rate: it has to give up at least one. Thus, the options available to a country are:

- (i) Exchange rate stability and monetary independence, without financial integration; known as the exchange rate stability approach; this strategy requires capital controls
- (ii) Financial integration and monetary independence, and no pegged exchange rate, known as the 'real targets' approach
- (iii) A pegged exchange rate and financial integration, but no monetary independence, known as the nominal anchor approach

Different exchange rate regimes can be implemented in support of these different options. An absolute fixed exchange rate regime (AFER), adopted under (iii) reduces potential transaction costs for imports and exports, which can have economic benefits; on the other hand, this approach can require high real interest rates, which may impose high costs on domestic producers, and encourage speculative capital flows and, indeed, speculative attacks. A country with AFER can lose its monetary policy independence. This also can have implications for fiscal policy: countries adopting AFER sacrifice real resources to obtain the currency of another country as a reserve against speculative attack, possibly at the cost of forgoing other expenditures that might have served important social objectives, including reducing poverty. An AFER enhances the credibility of the government by imposing restrictions on the government's ability to finance deficits through borrowing from the central bank and monetisation, thus keeping inflation low and improving the balance of payments. But such strict limitations on deficit spending can have negative effects for pro-poor public investment, and a very low rate of inflation is not necessarily important to the poor.

A pure floating exchange rate regime (PFER), adopted under (ii), enhances competitiveness by permitting currency depreciation in response to falling export demand. However, it leaves a currency subject to short-term oscillations the presence of which may increase transactions costs.

A fixed but adjustable exchange rate regime can be employed to minimize the disadvantages of AFER and PFER; however such an approach cannot eliminate the difficulties associated with the polar approaches which it mixes.

A developing country pursuing nominal stability must avoid harmful real exchange rate appreciation. Exchange rate depreciation can be an important tool for maintaining export competitiveness and, more generally, robust aggregate demand. The role of exports in industrial ‘learning by doing’ gives special importance to this point.

### ***3. International Trade and Investment Policies***

Gains from international trade can in principle contribute to poverty reduction, if gains in national income are sufficiently sizable, and well distributed, to lift individuals out of poverty. The view that trade liberalisation reduces poverty thus rests on two assumptions: that a liberalized trade regime in less developed countries will lead to gain in national income, and that these gains will in fact benefit the poor. Both of these assumptions are not always certain to hold, however. We will examine them each in turn in this section.

Two opening comments are in order. First, it is difficult to measure trade ‘liberalisation’, since different scholars have used different indicators of trade-related policy reforms, in Asia and elsewhere. Measures of protectionism often employed have included the unweighted or trade-weighted average import tariff, an index of effective protection, an average index of non-tariff barriers, indices of exchange rate misalignment, and the black market premium. In earlier decades, developing countries most frequently used non-tariff measures as the main instruments of controlling trade, through for example, employing negative lists specifying banned items, and imposing import quotas and licensing requirements. Because of the many different instruments of protection that have been employed it is difficult to arrive at uncontroversial measures of protection. Nevertheless, available data indicate that there has been a substantial degree of trade liberalisation in Asian countries in recent decades.

Second, liberalisation is in practice a complex process involving staggered reductions in tariffs, quotas and other barriers to trade. There is no universal path of external sector reforms and each such path is likely to have distinct effects, *inter alia* because the effects of trade policy are substantially dependent on complementary policies (exchange rate policy in particular). Policies that

provide sustainable access to foreign exchange and the resulting ability to import intermediate inputs, capital goods, and wage goods may be required to support rapid domestic growth. Other complementary policies may be required in order for liberalized trade to be effective at reducing poverty, and to be politically sustainable, even where it generates aggregate economic gains. In practice, countries have usually simultaneously undertaken other economic reforms such as privatisation and deregulation of industrial, financial, product and labour markets, so that where growth has occurred it is difficult unambiguously to attribute it to trade liberalisation.

All the countries considered here underwent substantial trade liberalization through shifts from quantitative restriction on imports to tariffs and progressive reduction of tariffs, along with the reduction or removal of export subsidies. Import tariffs, on average, at the end of the 1990s were one-sixth the level prevailing at the beginning of the decade in Bangladesh, about one-half in India, and one-third in Pakistan. Simultaneously, most countries allowed their currency to depreciate in real terms with the exception of Bangladesh and China. Most countries experiences an upsurge in exports. The growth rate of exports in India and Vietnam more than doubled. Stagnation of exports was observed only in the case of Pakistan.

In South Asia, trade (exports plus imports) as a percentage of GDP, which stagnated at about 21% between 1980 and 1990, has increased rapidly in the 1990s to reach 34% in 2003. In East Asia and the Pacific, the trade-GDP ratio has increased from 29% in 1980 to 45% in 1990 to 81% in 2003. Not only did Asia-Pacific as a region experience increases in trade, but it did so more than other developing regions in the world.

The share of the Asia-Pacific region in world's merchandise exports has more than doubled from 5.0% to 11.2% during 1990-2003. The region's share in world merchandise imports also nearly doubled from 5.4% to 10.2% in the same period. Similarly, Asia's share in world services exports increased by 75% from 3.6% to 6.3%.

A more interesting story emerges when comparing trade performance across sub-regions within Asia. While East Asia and the Pacific's share in the world's merchandise exports of goods more than doubled during the period 1990-2003, South Asia increased its share by only 43%. On the other hand, South Asia did reasonably well in services trade. While its share in world services trade has

more than doubled from 0.8% to 1.7% during 1990-2003, East Asia increased its share from 2.9% to 5.6% in the same period.

Among the country studied, only two countries (namely Mongolia and Pakistan) witnessed declining shares in global merchandise trade. Thus, the available data clearly indicates that Asia-Pacific developing countries have out-performed the other developing countries by a wide margin in terms of their share of world trade.

This high level of trade integration implies that international trade is of considerable and growing importance in the region's economies, although it is of lesser importance than in certain other regions. The country studies note that trade-GDP ratios increased markedly over the recent period during which trade liberalisation took place. There is evidence of export growth and export diversification.

### **The effect of international trade on economic growth**

In some instances trade liberalisation appears to have been accompanied by sustained (although not always increased, growth). However, it is not always straightforward to determine whether trade liberalisation is the result or the cause of observed growth.<sup>16</sup>

The doctrine of comparative advantage holds that countries can increase their real income and welfare by specializing in the production of products in which they have a comparative advantage. Where growth in aggregate national income occurs, it may be of two kinds: static (a one-time rise in income that is not accompanied by an increase in intermediate and long-run growth rates) and dynamic (an increase in the intermediate and long-run *rate* of growth of income).

Standard international trade theory supports the view that static gains will result from trade liberalisation for all countries, thanks to the specialization, and resulting efficiency gains, that it will make possible. Standard economic theory also recognizes, however, that there may some be reasons why trade

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<sup>16</sup> Rodrik, Dani, 'Trade Policy Reform as Institutional Reform,' in Hoekman, B.M., English, P., and Mattoo, A., eds., *Development, Trade and the WTO: A Handbook*, World Bank, Washington DC, USA, 2002.

liberalisation does not result in greater national income.<sup>17</sup> One such scenario is that in which a country has market power; the imposition of trade restrictions in such a context may increase national income as compared to free trade. It is true, of course, that such measures will benefit only one country and will diminish world income. The doctrine of comparative advantage is based on several such assumptions and gains its strength from a focus on one-time efficiency gains. Empirical evidence on whether trade liberalisation is associated with increases in economic growth is decidedly mixed.<sup>18</sup>

It seems plausible that in order to achieve the large beneficial effects on poverty touted by its advocates, trade liberalisation must also generate dynamic gains: that is, to permanently increase the rate of growth of national income. The theoretical basis for holding that international trade is likely to lead to such gains is weaker than the basis for the view that it leads to one-time efficiency improvement. Long-run gains are sometimes argued to come about through increased competitive pressure for innovation and productivity improvements, through creating improved incentives for innovation through the widening of the market, and by providing better access for inputs and ideas that play a role in technical innovation.

On the other hand, trade liberalisation may lead to allocations of resources that are statically but not dynamically optimal, for instance by diminishing the demand for domestically produced industrial goods and thus impairing the acquisition of industrial capabilities, or by diminishing government revenues from customs and excise duties [customs duties have commonly been one of the largest sources of tax revenue for developing country governments] and thus impairing the ability of government to undertake growth-enhancing activities. A country may end up specializing in slow-growing sectors, although it could have gained long-term benefits by investing early in sectors with rising demand. There may be insufficient private investment in such sectors in a fully liberalized economy due to the presence of externalities among firms (which do not fully internalize the benefits of long-term spillovers in the acquisition of technological, managerial and marketing capabilities), and the use of trade policies may provide one avenue for creating appropriate incentives for such activity. In many of the countries studied, export promotion has focused on

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<sup>17</sup> Reddy, Sanjay, and Nye, Harold, 'Making Trade Policy Work for the Poor: Shifting from Dogma to Detail', working paper, Columbia University, available on [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=944616](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=944616)

<sup>18</sup> For an important recent discussion, see F. Rodriguez and D. Rodrik, NBER, Working Paper No. 7081, April 1999.

obvious, common sectors such as textiles, and industrial policies appear to have been poorly chosen and implemented.<sup>19</sup>

The impact of trade liberalisation on economic growth may depend on complementary country characteristics and policies, e.g. infrastructural quality, and human capabilities, and the quality of institutions. Development strategies that aim to use exports as an engine of growth must rely on rapid rates of growth of world trade or on increasing shares of world markets—factors that are beyond government control. The world economy has been supportive of export-oriented strategies in recent decades, in a number of prominent cases. However, these have also very often been instances in which active policies of export promotion in the context of industrial policies have been pursued.

### **The effect of trade-generated changes in income distribution on poverty**

A growing literature identifies several key linkages between trade liberalization and poverty. Trade alters relative product and factor prices, and its net effect on poverty reduction depends on the signs of these relative product and factor price changes. For example, if exports are primarily of labour-intensive manufactures, then growth in exports could cause increases in relative wages of unskilled and semi-skilled labour, thereby contributing to poverty alleviation. This may have been the experience of East Asia in earlier decades. However, during the 90's, trade growth seems sometimes to have led to the emergence of urban 'enclaves', with beneficiaries consisting primarily of those directly involved in export activities and the limited auxiliary service functions that developed around these activities. For example, information technology exports from India and exports of garments from countries such as Bangladesh and Cambodia have remained restricted to a few urban centres. In the case of Bangladesh and Cambodia, exports may not have not contributed much to value-added because of high import content. The absence of backward and forward linkages has meant that the employment generation due to export expansion has not been as significant as hoped.

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<sup>19</sup> High levels of dependence on a single export can cause vulnerabilities. For instance, garment exporting countries such as Bangladesh, Cambodia and Viet Nam's have faced difficulties due to changes in demand for their exports due to the abolition of the MFA. See Ghosh, 'External Trade Policies and Poverty Reduction', p 23.

Recent findings on the effect of trade liberalization on poverty, after controlling for the rate of economic growth, are ambiguous. The direct effect on the incidence of poverty of trade liberalization does not appear to be significant in the Asian context (Pasha and Palanivel). The Asian experience on the impact of export performance on poverty is in line with some recent empirical studies based on global data. Studies such as Agenor (2002), Ghura et al (2002) and Epaulard (2003) [cited in Pasha and Palanivel] find weak inter-linkages between export growth and poverty reduction.

Aggregate national income growth will not reduce poverty unless the poor share in the gains. Such sharing cannot be regarded as automatic.

First we must recognize relevant structural differences between developed and less developed economies. Less developed economies are marked, *inter alia*, by relative labour abundance, lower skill levels, and segmented labour markets, and poor infrastructure. The Stolper-Samuelson theorem suggests that trade liberalisation will increase wages in countries with relatively abundant labour.<sup>20</sup> If the preconditions of the theorem were satisfied, one would expect trade liberalisation disproportionately to increase the income of the poor, insofar as their main asset is their labour. However, the assumptions of the theorem are restrictive and it cannot straightforwardly be generalized to more complicated cases better approximating reality. There is little consensus as to whether trade liberalisation causes increases in employment and wages in practice. Recent careful empirical studies of the effects of trade liberalisation on developing country labour markets have failed to resolve the ambiguity.

LDCs, including those in the region, are characterized by a relatively small urban formal sector producing manufactured goods and services, dwarfed by the informal urban sector and the agricultural sector. The poor, who are also likely to lack education and connections, are disproportionately engaged in the informal sectors, which produce non-tradable goods (subsistence farming and personal services), demand for which may not notably increase as a primary consequence of trade liberalisation.

In agriculture, lack of capital and economies of scale relative to international producers can diminish the international competitiveness of local farmers in LDCs, as cheap agricultural imports compete with local products, lowering prices. Analysis of the case study countries suggests that trade reforms

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<sup>20</sup> Reddy, and Nye, op. cit. p 39.

generally failed to promote substantial increases in agricultural exports and may even have adversely affected cultivation. Indonesia moved from being an agricultural success story in the late 1980s, with significant food surpluses and rice exports, to becoming a food importer with stagnant domestic production by the end of the 1990s. The Cambodian example suggests that even an apparently good performance in terms of agricultural exports can be associated with the exclusion of certain cultivators from the benefits of such trade. Large farmers appear to have benefited more from export growth. It is not surprising therefore that in Cambodia, agricultural trade liberalization has apparently not been strongly associated with rural poverty reduction.

Viet Nam is the only country among the case study countries in which agriculture appeared to exhibit strong overall output growth throughout the 1990s.

In China, agriculture is widely recognised as the sector most adversely affected by the terms of accession into the WTO, which have caused increases in import competition for producers of some important domestic crops. The effect upon Chinese farmers is still unknown and possible massive.

In Bangladesh and Nepal, the issue of trade liberalization is complicated by the long and porous border both countries have with India. For cultivators in these countries this makes India's trade policies possibly just as significant as their own. In both of these countries, agricultural performance has been poor, and in addition to the reduced viability of cultivation the problem of very large underemployment in agriculture remains significant.

More generally, it is clear that the agricultural sector seems to have played a limited role in overall export growth to date.<sup>21</sup> This may reflect the constraints of the current international market for agriculture commodities, in which subsidies and tariffs applied by developed countries are important factors.

The quality of employment in export industries can be weak. It has been suggested that the net effect of trade integration on manufacturing employment could also be negative, at least in the short term, because export production may be less employment intensive than local production that is displaced by imports. There is some evidence that the service sector, rather than the industrial sector, has now emerged as the sector providing refuge for individuals who cannot

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<sup>21</sup> Ghosh, op cit p 27.

make a living in agriculture. Across much of Asia, labour force participation rates appear to have declined in the 1990s.<sup>22</sup>

It appears that the effect of aggregate growth on the incomes of the poor depends significantly on the extent to which the workers who benefit directly from freer trade increase their consumption of the services of workers in sectors with weak links to international markets. Poor infrastructure and geographic isolation, which contribute to segmentation of the economy, will be factors in this. It is notable that regional inequalities have increased during some successful export driven development experiences.<sup>23</sup> Even the urban poor may fail to benefit from trade-driven economic growth if those workers who do benefit from increased incomes expand their consumption of imported goods rather than local services.<sup>24</sup> The overall result of greater international trade can be output growth with insufficient employment generation.

One reason why increased trade may not lead to pro-poor growth is that high rates of growth are matched by very high import growth in almost all economies. Some literature on trade liberalisation indicates that in the initial stages of trade liberalisation, a country's balance of payments may worsen, because when import and export restrictions are reduced, a rise in imports may occur faster than the export supply response. However, available evidence indicates that balance of trade as percentage of GDP improved in most of the countries studied in the 1990s as compared to the 1980s levels. Only Cambodia, Lao PDR, and Nepal experienced worsening trade balance in the 1990s compared to levels in the 1980s.

While the theory of competitive advantage suggests that imported goods will be less costly than the locally-made ones that they replace, the prices of other (exported) commodities can rise, both because of increased foreign demand and increased local demand caused by rising incomes for some.<sup>25</sup>

The effects of trade liberalisation on public finance are also complex. As discussed elsewhere in this paper, public expenditure is critical to poverty reduction. Trade liberalisation can potentially have a negative public finance impact for a number of reasons. Most importantly, as already noted, tariffs on internationally traded goods are one of the primary and most reliable sources of

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<sup>22</sup> Ibid, citing *Global Labour Trends 2003*, International Labour Organization (ILO), Geneva.

<sup>23</sup> For example, in China and Korea; *ibid* p 23.

<sup>24</sup> Reddy and Nye, *op cit.* p 44-45

<sup>25</sup> Reddy and Nye, p 49.

tax revenue for developing countries, which may have few tax handles available to them; the larger the informal relative to the formal sector, the greater the degree to which this is typically true. It has also been argued that implementing WTO agreements creates a fiscal burden.<sup>26</sup> On the other hand, the static and dynamic gains from trade may result in increased tax revenues.

Sequencing of liberalisation of exports and imports is important to maintain competitive real exchange rates, improve balance of payments and increase growth.

#### ***4. Privatisation and the Management of Public Enterprises***

Privatisation has been urged on developing countries as a way to improve public finances, spur growth and even reduce poverty. Unfortunately, there have been relatively few careful empirical studies of its effects. To the extent that the consequences of privatisation have been studied, its distributional and social welfare consequences have been largely overshadowed by a focus on ‘efficiency’, understood narrowly in terms of output and profits.

Privatisation can have several different aspects including a) privatisation of common lands, minerals, forests and other natural resources; b) partial or wholesale privatisations of state-owned enterprises (SOEs); and c) provision for private sector participation in sectors previously under public control, such as water and electricity utilities, services (such as telecoms), and infrastructure.

Whether privatisation has, in specific countries, enhanced growth, efficiency or poverty reduction, requires empirical research. Unfortunately, the case studies reveal a lack of systematic data on privatisations, especially in sectors that may be expected to have considerable effects on the poor, such as services, utilities and infrastructure. Thus, while we can draw some conclusions on the effects of privatisation, they are perforce on the basis of inadequate data.

It is helpful to assess privatisation’s impact on poverty through its effect on three intermediate factors: efficiency in production, labour markets, and fiscal balance. The final impact of privatisation on poverty depends on its impact on these indicators and the implications of this impact for poverty reduction.

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<sup>26</sup> Palanivel, T., “Trade Liberalisation, Macroeconomic Performance and Poverty Reduction”, UNDP, p15

## **Privatisation of rural assets and common resources**

The ownership structure of productive assets in the rural sector is of crucial significance in poverty reduction, because there is typically extensive poverty in rural areas. Landlessness and ownership of marginal land are associated with this poverty. One form that land reform has taken has been to seek to privatise commonly held or state-owned land.

This form of land privatisation can have an impact on poverty where it effectively entails progressive asset redistribution, because the de facto prior use patterns of existing communal or state-owned land were inequalitarian (a presumption which may not always be correct). Whether such privatisation has brought long-run benefits also depends on whether new owners exercise their right to sell land and on the purposes to which these gains are put.

Privatization of rural assets has been common in the transition economies in Viet Nam, Cambodia and Mongolia. In Viet Nam, households were given long-term use rights over land but not ownership. In China, land continues to be owned and managed by village governments or collectives. The case studies suggest that privatization may produce positive results if it is carried out through asset redistribution in environments where the initial distribution of assets was highly skewed and rural poverty was high. However, in Mongolia, the privatization of livestock, the main productive asset for most rural households, is reported to have increased inequality.

The case studies also provide some examples of privatisation of common resources having adverse impact. For example, it is suggested that local communities in Cambodia have been harmed by privatisation of common forests, and fisheries have been damaged by siltation and chemical runoff, and that these concessions had a neutral or negative fiscal effect.<sup>27</sup>

It is also suggested that privatisation, considered strictly as giving individuals ownership, is less effective in reducing poverty than giving the same individuals long-term use rights.<sup>28</sup>

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<sup>27</sup> Dagdeviren, H. and Fine, B. "Privatisation and Poverty Reduction", p17.

<sup>28</sup> *Ibid.*, p15. This prevented inequalities that might have developed at later stages; in Viet Nam rural poverty declined substantially.

Finally, we can say that broadening asset ownership for rural communities is not sufficient to reduce poverty unless supporting public investment are made to ensure and enhance the productivity of these assets through the provision of infrastructure and services such as road and transport networks, irrigation systems and watering facilities for livestock.

With regards to privatization and access to common resources, the Cambodian and Mongolian case studies highlight the drawbacks associated with market-based resource management systems in the rural sector.

### **State-owned enterprises**

In recent years, the assumption that the degree of efficiency of an enterprise is dependent on the form of ownership has contended for influence with the notion that ownership is less important than the conditions under which an enterprise is subject to competition and regulation. Indeed, the case studies do not unequivocally show that privatisation improves the performance or efficiency of SOEs. For example, the Bangladesh, Nepal, China and India case studies all report mixed outcomes. The role of the competitive and regulatory environment needs to be carefully analyzed.

It must be recognized that privatisation does not involve just the retreat of the government—far from it. Rather, it requires the state to take on new responsibilities, and acquire new capacities. Public sector officials will have to develop more sophisticated skills and greater knowledge of industrial and market environments in order to regulate newly private markets.<sup>29</sup> This proposition has been often neglected by proponents of privatisation, who have frequently ignored the fact that developing countries may not have sound institutions to govern the market and that they may not have markets with high levels of competition.

The degree of effective competition is determined not just by the number of actual or potential market participants, but by a variety of factors, including access to finance, technology and skills, degrees of horizontal and vertical integration, etc. ‘Regulation’ in turn encompasses anything that the government might do to limit to or prescribe actions of private enterprise.

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<sup>29</sup> Jouravlev, A. “Water Utility Regulation: issues and Options for Developing Countries” Report for Natural Resources and Infrastructure Division, Economic Commission for Latin America and the Caribbean, 2000, cited in Dagdeviren and Fine, *ibid.*, p18.

Efficiency can be defined in different ways. It has often been conflated with the attainment of output objectives, without regard for social goals that could plausibly be integrated into the efficiency concern. The apparent efficiency (understood in the narrower sense just described) of both public and private enterprise in a country can owe a great deal to general macroeconomic conditions. Sifting out the effect of ownership from other factors can be difficult. Overall conclusions can therefore be difficult to draw.

### **Effects of privatisation on labour markets**

In most countries studies, privatisation was accompanied by expansion of the informal labour markets and substantial layoffs. Available data suggest the closure rate amongst privatised SOEs was over 20%.<sup>30</sup> This naturally leads to large short-term job losses in urban areas and can contribute to poverty. There is some suggestion that workers laid off from SOEs are likely to be older and less skilled, and thus more difficult to re-employ. Many unemployed workers shift to the informal sector, where social protections are much less.

The long-term effects on poverty of these spikes in unemployment will depend on whether there is subsequent growth of private-sector employment. Naturally, whether this growth occurs depends on a host of macroeconomic conditions beyond the scope of privatisation policy. However, to minimize the effects of privatisation on poverty in the short-term, basic social safety nets should be put in place prior to privatisation. Indeed, if private enterprises in general provide a lower level of social protection, certain social services such as health care and retirement provisions can be maintained or developed by the government.

### **Privatisation and fiscal outcomes**

In order for the government to take over the responsibilities, develop the capacities, and provide the social services implied by a pro-poor privatisation policy, sound fiscal performance is essential.

Privatisation can affect fiscal performance in three ways, though: a) sale proceeds net cost of privatisation, b) foregone or offloaded profits/losses of SOEs, and c) the contribution of privatised enterprises to tax revenues.

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<sup>30</sup> Dagdeviren and Fine, op cit., p 23.

With respect to sale proceeds, in general the expectations of governments appear not to have been realized in the case study countries except in China and Indonesia. In Bangladesh, for example, net proceeds were usually negative.<sup>31</sup> There are several possible reasons for this, including corruption in the sales, or lack of investor interest (perhaps due to generally poor economic conditions). If the latter is the main problem, sales might simply be delayed until conditions improve, rather than heavily discounting assets. Privatisation also has costs including severance payments, legal fees, and the cost of running the privatisation agency, all of which affect the net gains of the government from a given privatisation exercise.

Many SOEs make accounting profits, and as a result have a positive effective on the government's fiscal position. Whether these profits are lower than those which privatised enterprises would make is, of course, a distinct issue. Moreover, it is necessary to take account of the distributional and social welfare objectives that may be served by SOE in determining the revenue impact of privatisation. If the pursuit of these objectives by SOEs is a factor that generates direct or opportunity costs, it is not straightforward to assess the economic and revenue impact of privatisation. These objectives must be achieved after privatisation through other subsidies or interventions, which will in turn have their own costs.

As for tax revenues, absence of information on the contributions of privatised enterprises is a major source of concern, but it is impossible to draw conclusions. Such anecdotal evidence as exists suggests that the taxes paid by newly privatised enterprises does not compensate for the loss of direct revenue to the government; however, this may be due as much to lack of administrative or political capacity of the government to collect taxes as from the economic performance of such businesses. To privatise an enterprise is to create a political constituency (the new owners) in favour of minimal taxes and regulation, and it can reasonably be expected that this constituency will assert itself, employing the resources of the newly-privatised enterprises to help them achieve their objectives.

## ***5. Financial Liberalisation***

Financial liberalisation is the process of diluting or dismantling regulatory control over institutional structures, instruments and activities of agents

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<sup>31</sup> Dagdeviren and Fine, op cit.

participating in the financial sector. The argument for financial liberalisation is that it encourages competition between financial firms leading to greater efficiency in financial intermediation, and thus to greater aggregate savings and a lower cost of credit, thereby encouraging investment and economic growth. The argument is also sometimes made that a lowered cost of credit will especially benefit the poor, who have high levels of indebtedness and who may have few sources of credit with which to ensure adequate consumption and to engage in productive investment. Credit arguably ought to be considered a quasi-public good in the manner in which other nominally private goods such as education are sometimes thus considered, due to the large developmental spillovers associated with it, and many developing-country governments have treated it as such: public institutions and policies have been constructed to provide it, especially to priority sectors.

Government involvement in the financial sector, like the government's role elsewhere, has been often criticized as inefficient. However the need for some government intervention, or at least regulation, is perhaps more clear in the financial sector than in any other, because the critical importance of finance for growth is matched by the economic chaos that can follow from instability in the sector. Indeed, developed countries maintain high levels of regulation of the financial sector. The move from an undeveloped financial sector into a developed one requires that the government take on new roles requiring new expertise.

Financial liberalisation can consist of a host of different policies, including:

- Removing obligations to direct credit and restrictions on interest rates
- Reducing controls over the investments that can be undertaken by financial agents (e.g. permitting banks to participate in the insurance or the mutual fund business);
- Expanding the sources of funds and forms of borrowing, (e.g. making it easier to issue commercial paper or certificates of deposit in the domestic market).
- Liberalizing the exchange control regime, providing for decentralized borrowing and lending in foreign currencies and from foreign lenders or borrowers
- Converting development banks into regular banks and privatizing the publicly owned banking system
- Weakening listing conditions for stocks, allowing greater freedoms for equity market participants (such as brokers and investment houses) and

relaxing conditions for borrowing against shares and investing borrowed funds in the market.

- Relaxing the rules governing mergers and acquisitions (such as the declaration of share acquisitions that can lead to takeovers)
- Relaxing guidelines on capital adequacy, accounting norms and related practices
- Removing or reducing controls on the entry of new financial firms, both domestic and foreign.

It is not possible here to address individually the effects of each of these and other policies, although we will attempt to look broadly at the effects of such liberalisation.

### **Potential Dangers of a Liberalised Credit Market: Misallocation, Cost, and Fragility**

A key problem of financial liberalisation is that the private rate of return may differ from the ‘social rate of return’—that is, lending or investment that would have the greatest impact on social objectives such as poverty reduction is not necessarily that which will provide the greatest return to private investors. Indeed, some such lending may be perceived to carry such high risk that private lenders would provide credit only at prohibitive interest rates. Thus, in a privatised and unregulated financial sector, socially valuable poverty-reducing investments may not be made.

#### *A) Misallocation of Credit*

For example, a completely privatised capital market may not provide sufficient investment in infrastructure. Although it is necessary to long-term economic growth, infrastructure can have a very long gestation period, high costs, high risks and diffuse benefits, making it potentially unattractive for private capital investors. Government intervention to complement private investment or directly to provide investment in needed infrastructure can thus constitute an important contribution to creating the conditions for economic growth.

Similarly, state-owned financial institutions, such as development banks, may direct credit to specific sectors, such as agriculture or small-scale enterprises in which the poor are engaged; or to manufacturing that creates low-skill jobs that the poor may take up. The principal rationale for development banks is the failure of private financial agents to provide certain kinds of credit to certain

kinds of clients. Development banking is required because social returns can exceed private returns in these activities. Industrial development banks can help local industries achieve economies of scale and agricultural development banks can advance subsidized credit to small and marginal farmers (who could be excluded by commercial banks and forced to rely on expensive informal sources of credit).

When state-owned financial institutions are privatised, the government is no longer able to allocate credit directly to priority sectors, although it may require private lenders to undertake lending to priority sectors.

*B) Prohibitively high cost of credit*

When privatisation is undertaken in the absence of regulations of credit, the composition of loan portfolios will be determined by profit-making imperatives. Privatised institutions are likely to be more risk-averse, and to have more stringent collateral requirements, than public institutions pursuing social objectives, and thus to limit investment by those who have inadequate capital. Where unregulated private actors such as individual money-lenders do lend to the poor, it can be at prohibitively high rates of interest, in contrast to government-directed credit institutions pursuing social objectives which, if they function effectively, may lend at lower interest rates than the prevailing market rate, which they may do deliberately in order to facilitate the take-up of credit and the growth of enterprises they desire to foster.

Advocates of financial liberalisation argue that the possibly higher risk-aversion of private lenders can be offset if the liberalisation package also includes easier conditions of entry into the financial sector that increase competition, thus holding down rates of interest. However, this need not necessarily occur. Where financial liberalisation allows domestic and foreign players to acquire firms, it can trigger a process of consolidation, resulting in fewer players in the market and reduced competition, especially where public actors withdraw. The cost of credit can thus rise, affecting pro-poor growth by shifting the composition of incremental investment away from projects benefiting the poor. Poverty reduction can thus be slowed both by the privatisation of institutions and by the dilution of rules that direct credit to “priority sectors” such as agriculture, urban small scale enterprises and rural non-agricultural activities.

A tactic governments might adopt to hold down the cost of credit to the poor after privatisation is to cap rates of interest that can be charged, thus attempting to ensure the availability of credit at reasonable rates while undermining the

incentive of banks to compete for the highest rates of return by taking on the most risky loans, and ensuring prudent loan selection. Of course, an adverse consequence of such an approach will be credit rationing. However, such rationing can occur even in unregulated contexts.<sup>32</sup>

*C) Increased fragility of financial markets and risk of market failure*

Liberalisation can mean freeing banks to offer a greater range of financial assets to their customers. Under a liberalized regime, banks change from being the principal bearers of financial risk to generating financial assets that transfer risks to a portfolio of institutions willing to hold them.

Such liberalisation can increase the risk of financial market failure. Orthodox neoclassical theory of financial markets is based on three assumptions: that markets are competitive, that sufficient information is available to all market participants, and that these participants act adequately ‘rationally’, on the basis of this information. These conditions ensure that financial markets function efficiently, in which case abrupt re-valuations of assets without underlying changes in underlying ‘fundamental’ factors would be unlikely. The combination of access to perfect information and competition between suppliers of capital and borrowers ensures that capital is allocated to the best projects (i.e. those with the highest rate of return, at a realistic rate of interest).

These assumptions need not hold true, however: competition may be undermined, and information, since it has strong public-good characteristics, is not necessarily profitable to create or distribute and can therefore be insufficiently supplied. Of course, government-owned development banks may also experience a high rate of default thanks to high-risk lending or inappropriate loans made due to political influences, corruption, and other factors leading to government failure. Even in developed economies, lack of accountability and political interference can lead banks to make bad loans with an ultimately high cost. Following liberalisation in less developed countries, including the relaxation of regulation, inexperienced banks may make poor lending decisions or dally in new financial instruments that neither they nor consumers fully understand. Some fear that in a short-termist attempt to attract deposits, banks may offer unrealistic rates of interest, or lend imprudently. The government may try to prevent or mitigate such occurrences through appropriate

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<sup>32</sup> Stiglitz, J.E., and A Weiss. ‘Credit Rationing in Markets with Imperfect Information’ *The American Economic Review*, Vol. 71, No. 3 (Jun., 1981), pp. 393-410.

regulation, although it cannot be assumed that it will always have the capacity to do so.

Where banks do fail, depositors (including the poor) are at risk of losing these savings unless the government steps in to cover losses. Where governments intervene in this way, the cost to public finances can be high and a moral hazard can be created that encourages risky behaviour on the part of banks in the future. However, refusal to intervene could have an adverse affect on poverty and generate a mistrust of the formal financial sector that will return small-scale savers to informal, low or negative forms of saving while failing fully to channel available savings into the most productive investments.

This thicket of considerations may make some question the rationale for privatisation: state-owned banks, backed by the finances of the government, are less vulnerable to collapse; where they do make bad loans this may be no more costly than the bail-outs of private institutions in the face of market failure.

## ***6. The Importance of Sequencing of Policies***

All of the above sections on diverse macro-economic policies have referred to the interdependence of such policies. In many cases, policies that are categorized distinctly are so intertwined that their effects cannot be effectively analyzed independently of others. Because our entire exercise here concerns the effects that it may reasonably be anticipated that specific policies will have on the poor, we must look carefully at each of these of interdependences. One type of interdependence is worthy of special mention precisely because it is often overlooked: inter-temporal interdependence. Policies that are interdependent may often have to be implemented in a particular order to be effective.

For example, the literature on trade liberalisation indicates that in the initial stages of trade liberalisation, a country's balance of payments can worsen, because when import and export restrictions are reduced, the rise in imports may occur faster than the export supply response. Thus, it could be desirable to liberalize export and import regimes in a staggered fashion, or to liberalize imports of capital goods and intermediate inputs used in export production prior to liberalizing other imports, as a tactical means of maintaining a competitive real exchange rate and viable balance of payments.

## **Constructing a Market Economy**

When the government retreats from the provision of certain services, steps must be taken to ensure that a private market in these services has the necessary preconditions, and adequate time, to develop. It cannot be assumed that such markets will emerge instantaneously and spontaneously. Indeed, rather than creating greater opportunities for private enterprise, hasty and unplanned privatisation could even undermine private enterprises that depend on the public services that suddenly disappear.

For instance, small-scale agricultural producers who may for lengthy periods have relied upon government-provided agricultural extension services such as provision of seeds, veterinary services, maintenance of wells, and assistance during droughts, may not readily be able to maintain production when these services are precipitately withdrawn. Such a phenomenon appears to have occurred in Mongolia, where the government retreated rapidly from such activities, leading to the collapse of rural agricultural markets, according to one of the case studies.<sup>33</sup> In some instances it may be possible for such services ultimately to be privately provided, and in other instances active government support (at the least) may be necessary to ensure their continuance. Services with a strong public good aspect (such as agricultural extension services) are likely to be of the latter type.

## **Establishing Regulatory Regimes**

An important sequencing consideration involves the importance of creating regulatory regimes—e.g., tax laws, labour, and financial regulations—prior to government withdrawal from direct involvement in the production and provisioning of goods and services and privatisation. In many cases creation of such regulatory regimes will constitute a new area of endeavour for the government, and must be undertaken well in advance of other economic reforms. If monitoring and enforcement regimes are not in place prior to the need for them, the economic and political costs of implementing them may become higher.

For example, because many publicly owned enterprises are profitable, after accounting for one-time sale-generated revenues, privatisation can reduce ongoing government revenues. The adverse implications of this reduced

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<sup>33</sup> Dagdeviren, H., and Fine, B., 'Privatisation and Poverty Reduction', UNDP, p 17.

revenue for public finance, and in turn poverty reduction, can be offset by the creation of appropriate taxes on these privatised assets or the income that they generate. Such a tax system must include both creating a suitable legal framework (e.g. creating an effective mechanism of corporate taxation) and developing the capacity of the government to enforce the legal regime.

Macroeconomic changes such as privatisation also inevitable create political interests. In the case of privatisation, a newly powerful class of owners (or more powerful, if existing economic elites avail themselves of the opportunity of privatisation to acquire former SOEs), whether domestic or foreign, will employ its economic and political power to resist taxation. These interests may resist taxation and regulation no matter when the regime is inaugurated but may be more likely to succeed once their interests in doing so are made more concrete through privatisation. Thus, countries planning for the privatisation of SOEs must not only consider the effect of this on public revenue and how a new tax regime may offset the government's loss of profits, but would do well to ensure that the new tax regime is in place, and indeed that a cadre of officials is trained to enforce the regime, well before the sale of SOEs takes place.

SOEs in developing countries play a significant role in the creation and development of formal labour markets and in setting labour standards, because of their pursuit of 'stakeholder' objectives going beyond profits, their susceptibility to political pressure, and other factors. Where investment is liberalized and SOEs are privatised, there may be incentive for the newly private enterprises to increase profit by diminishing real wages and labour standards. It may therefore be desirable to ensure that privatisation is complemented by the creation of an effective system of national labour standards monitoring and enforcement. As with new tax regimes, clear economy-wide labour standards promotion mechanisms should be in place in advance of privatisation, and governments must ensure that a sufficient number of public officials are trained to monitor and enforce adherence to these labour standards and that courts are equipped to deal with related legal actions.

Where the government chooses, under a privatised regime, to continue to direct credit or to provide preferential interest rates for specific sectors, these policies will have to be accomplished through subsidy or regulation. To be effective, a suitable governmental framework for promoting these aims should be in place before privatisation takes places, so that purchasers understand the terms under which they can expect to operate.

## **Providing Social Safety Nets**

Although they may be undertaken with pro-poor, long-term growth in mind, macroeconomic reforms by definition will create changed economic conditions that may endanger the security of poor households. In the section on trade policy above, it was noted that dropping of tariff barriers often led to falling commodity prices for poor agriculturalists. Agriculture will be discussed again below, but from the perspective of sequencing, we emphasize here the importance of having social safety nets in place to cushion economic dislocation of the poor engaged in agriculture.

Similarly, it is essential that adequate social safety nets, including unemployment benefits and job re-training measures, are put in place before privatisation. We cannot say with certainty whether privatisation increases or decreases in employment, since in the long-term this will depend on the extent of subsequent overall employment growth. There is some suggestion that workers laid off from SOEs are likely to be older and less skilled, and to suffer subsequent downward mobility, but this evidence is extremely limited.<sup>34</sup> Regardless, it is only prudent for any pro-poor policy to encompass provisions for social safety nets well in advance of changes that may affect employment levels.

### ***7. Complementary Measures essential to the success of a Pro-Poor macroeconomic policy***

Whether macroeconomic policies have the effect of reducing poverty does not depend on these policies alone but also on what complementary policies are employed. In particular, such complementary measures encompass suitable microeconomic interventions. We consider here two especially important kinds of complementary measures in particular, although it is possible to think of many others.

#### **Asset distribution**

Individuals' capacity to benefit from opportunities to participate in markets and a supportive macroeconomic framework can depend on their possession of adequate assets — which they may employ either directly, as a means of production for the market, or indirectly (e.g. as collateral used to procure loans for investment in physical capital or human capabilities). From this standpoint, the possession of a relatively egalitarian initial asset distribution, ensuring the

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<sup>34</sup> Dagdeviren and Fine, op cit.

possession of assets which are adequate for persons to arrive at the ‘starting gate’ of a competitive market economy, is essential to the success of pro-poor macroeconomic policies.

Policies that ensure a broad-based initial distribution, or the ability to procure such assets over time, are therefore essential to maintaining a pattern of growth which is inclusive and poverty-reducing. Policies that can be used to achieve such an initial distribution of assets, or to bring about a more egalitarian distribution of assets over time include land reforms, investment in human capabilities (in particular, basic education and health care), the provision of credit and the creation of cooperatives for production and marketing..

### **The Special Role of Agriculture**

Agriculture is a subject worthy of special consideration for at least two reasons. First, it is important to note that agriculture is a source of livelihood and not just a sector of production. This idea has figured significantly in WTO negotiations, and has been especially emphasized by certain countries (in particular, India).

Second, despite the focus on rapid industrialization as the key to economic growth and poverty reduction, a majority of the poor in the countries studied are still engaged in agriculture. Any policy changes, for good or for ill, that affect agriculture will therefore have a disproportionate effect on the poor. In addition to the role of agriculture as a source of livelihood, it must be recognized that most agricultural commodities are foods, which are essential for survival. Agriculture is therefore of great significance to the poor on both the “production side” and the “consumption side” and must accordingly figure centrally in the design of pro-poor macroeconomic policy. Although there is not space here to elaborate such considerations in details, we briefly note the following examples of methods through which this special role of agriculture has sometimes been taken note of in the past, and can be taken note of in the future:

- Schemes for stabilisation of agricultural prices on both the production and the consumption sides, through maintenance of buffer stocks, public systems of food procurement and distribution, and other mechanisms
- Use of price indices in macro-economic management which emphasize the importance of essential commodities, especially food
- The application of import tariffs where required to protect employment in agriculture

- The safeguarding of foreign exchange sufficient to meet essential commodity import requirements, especially of food.

## **9. Conclusions**

We have shown that there are a great many complexities that have to be taken into account in the design of pro-poor macroeconomic policies. However, it is possible to identify some lessons that ought to be of importance for policymakers, including the following:

### **Fiscal policy**

- The ‘fiscal reforms’ should not aim merely to maintain a stable macro-economic environment but also to foster a framework for sustainable and inclusive growth
- Fiscal sustainability can best be attained by expanding the tax base and improving tax administration, and not merely by reducing expenditure
- Heavy reliance on regressive indirect taxes should be avoided
- The golden rule – maintaining surplus (or at least balance) within the recurrent budget; deficit financing of the development budget can be acceptable
- Increasing expenditure on social sectors is not always pro-poor. Expenditure switching in favour of social sectors at the expenses of vital economic sectors may have medium and long-term adverse implications for the poor. However, fiscal buoyancy may make such difficult choices unnecessary.

### **Monetary policy**

- Avoid extremes of conservatism and expansionism in monetary policy, neither prioritizing extremely low inflation nor permitting hyperinflation
- Seek consistency between monetary and fiscal policy through appropriate coordination between government monetary and fiscal institutions, including the central bank

- Develop directed credit programmes for employment-intensive SMEs, agriculture and rural industries, even when overall credit growth needs to be restrained, to avoid adverse impacts on employment.
- Central banks should have instrument autonomy subject to their pursuit of the overall economic objectives dictated by the poverty reduction strategy of the government.

### **Exchange Rate Policy**

- The choice of what exchange rate system to adopt depends on a country's characteristics: a country that has been characterized by high inflation and macroeconomic instability may wish to adopt the absolute fixed exchange rate, for a period of time.
- Over the long term, follow an intermediate exchange rate regime, one that combines some control over exchange rates with monetary independence and some control over capital flows.
- The pursuit of nominal stability does not end up bringing about excessive real exchange rate appreciation.
- A country should be able to switch approaches in times of crisis: when there is a negative shock or when a boom ends, a country should be able to adjust its exchange rate downwards—the 'real target' approach.

### **International Trade and Investment Policy**

- Trade liberalisation is associated with increased trade volumes (ratios of trade to GDP), but its relations both to long-term growth and to poverty reduction are not well established.
- There is some evidence in all the case study countries that the linkages between export sectors and the rest of the economy are such that the poverty-reducing effects of export growth may be limited. Export promotion and import liberalisation are distinct policies with distinct consequences for aggregate income and distribution.
- Successful—growth-enhancing and poverty-reducing—efforts at export promotion appear historically to have been accompanied by a range of complementary policies, including import substitution policies in

particular areas, selective fiscal incentives, preferential access to credit, and a government role in coordinating private actors. Export-orientation may or may not be enhanced by trade liberalisation.

- There is no single path to external sector reforms. Each country must develop its own path depending on resource endowments and constraints. It is particularly important that trade liberalisation must be coordinated with other macro reforms, especially industrial and exchange rate policies.

### **Privatization Policy**

- The evidence in the case studies does not appear to show that the outcomes of privatisation have been unambiguously positive. asset concentration took place in some governments after privatisation. privatisation of rural assets appears to have led to the collapse of rural markets in mongolia as markets failed spontaneously to emerge to fulfill the functions previously undertaken by the government, as had been hoped for by supporters of the privatisation.
- Evidence on enterprise performance drawn from literature outside the case study countries is mixed. it appears that ifis may often over-emphasize the revenue-generation effects of privatisation and the potential to use this revenue for social purposes.
- SOEs in developing countries play a significant role in the creation and deepening of formal labour markets and in setting decent labour standards. privatisation can undermine this role in some instances, as well as leads directly to layoffs and subsequent casualisation. however, no blanket statement is possible concerning the effects of privatisation in this regard, as the role of soes in establishing and sustaining labour market norms has varied across countries.<sup>35</sup>

### **Financial sector liberalisation**

- Studies of the 1997 Asian financial crisis show that many years of poverty reduction through economic growth were reversed in just a few months. Although the Asian crisis was caused primarily by volatility in national capital accounts due to international investment flows, as opposed to failures of domestic banks, it dramatized what the abrupt constriction of credit can do

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<sup>35</sup> Breman, J. *The Making and Unmaking of an Industrial Working Class: Sliding Down to the Bottom of the Labour Hierarchy in Ahmedabad, India*. Amsterdam University Press. 320 p. 6-1/4 x 9-1/2 2003.

to economic growth. Many firms were forced to close, increasing both unemployment and poverty.

- The case studies show that reforms associated with liberalisation can cause a contraction in credit provision to ‘priority’ sectors and a rise in real interest rates paid in these sectors. A simultaneous move away from directed credit and differential interest rates may bring about recession in specific sectors (for instance, the agricultural sector) which had previously benefited from directed credit, even if such an outcome does not result in the aggregate economy.
- Directed credit—either through state-owned institutions or through regulation of privately-owned institutions—can be beneficial to retain. Subsidized credit can combine the task of promoting productive investment with that of improving asset and income distribution and generating employment in semi-urban and rural areas and have a notable impact on poverty. Arguably, the best insurance against failure in the financial sector is that liberalisation is gradual and carefully sequenced so as to permit the development of government expertise in regulation. more than other sectors, financial markets are vulnerable to panics and crashes, and require the development of adequate financial knowledge, on the part of regulators and market actors generally, without which liberalisation can lead to fragility of financial institutions or of the financial system as a whole.

### **Overarching Lessons**

- Public investment plays a crucial role in sustaining a high level of growth and ensuring that its benefits are widely distributed. It can be inappropriate to emphasize fiscal balance over the provision of “developmental stimulus”, especially when fiscal deficits are maintained in a range that is low to moderate and are used to finance development promoting investment.
- The attainment of extremely low inflation should not be a goal in itself. Central banks must take into account the government’s overall economic objectives, including those related to employment and growth, in establishing monetary targets.
- Complete convertibility of the capital account is frequently inadvisable for developing countries, because of their relatively small size in the world economy, and the propensity of financial markets to “manias, crashes and panics”. The adverse impact of events such as speculative attacks on

exchange rates and internationally “contagious” asset price deflation episodes can be limited if a degree of non-convertibility is maintained.

- Export promotion may not always be enhanced by trade (especially import) liberalisation. it can be valuable to maintain “policy space” for commercial policy to be employed in pursuit of developmental objectives, although such measures must be employed with care. Moreover, complementary policies which enhance the capabilities of firms and workers in a broad-based manner are essential if export oriented policies are to be successful in promoting growth and to have a pro-poor character.
- Privatisation is best undertaken with care, taking note of potential adverse consequences. it must be prepared for adequately with appropriate sequencing and the implementation of suitable complementary policies. Effective poverty reduction can require that government maintain a direct or indirect role in the provision of credit to social priority sectors
- For reforms to have a pro-poor dimension, the government must strengthen its capabilities in new areas, developing tax regimes, social safety nets, and measures to promote labour standards. Agriculture requires special consideration in macroeconomic and trade policy design, in recognition of its role as a source of livelihood

It can be hoped that the absorption of such lessons by policymakers in the region and their context-specific application will make for more effective policies that serve the interests of the masses of people, most especially the poorest.

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