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## **ABBREVIATIONS**

FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
MDGs	Millennium Development Goals
OECD	Organization of Economic Cooperation and Development
PRSP	Poverty Reduction Strategy Paper
UN	United Nations
US	United States
VAT	Value Added Tax
WTO	World Trade Organization

# **PURSuing GROWTH POLICIES: CAN KENYA LEARN FROM PAST BEST PRACTISES?**

## **1.0 Introduction**

Since the 1990s, many developing countries including Kenya have had remarkable success in reducing inflation, as well as improving fiscal and current account deficits. According to Levine, Ross et al (1992), countries have not been as successful at achieving stability of macroeconomic output and sustainable growth. This is in large part because stabilization policies have focused on price stability – even though *real* stability, not price stability, is what's ultimately important for attracting investment and achieving sustainable development.

This policy paper lays out a framework for designing macroeconomic policy geared toward real macroeconomic stability *with* growth. This framework is based on the view that there need to be broader goals, additional instruments beyond fiscal and monetary policies (including capital account management, regulations, and other microeconomic tools), and a balanced role for government and the private sector. In addition, policymakers need to coordinate fiscal, monetary, exchange rate policies and design programs based on flexibility and the individual needs of each country.

This policy paper is divided into three sections. The first discusses macroeconomic objectives, and the need for a broader set of policy goals. The second examines the conventional tools of macroeconomic policymaking: fiscal and monetary, and exchange rate policies. The third and final section of this note looks at alternative tools for macroeconomic management, with an emphasis on interventions in capital markets. Some of the issues discussed, such as public sector revenue mobilization, are relevant to current policy choices in both low income and middle income countries. I hope the discussion will give all policymakers ideas of creative measures that can be used to overcome market failures in countries like Kenya.

## **2.0 Macroeconomic Objectives**

I begin the discussion by focusing on the objectives of macro-economic policymaking. At the most general level, the goal of economic policy is to maximize long-run societal well-being in an equitable and sustainable manner. Much of the recent discussion of economic policy has focused on intermediate variables, such as price stability or the balance of payments. Intermediate variables, however, are not important in their own right. Their importance derives largely from their role as possible indicators of economic performance in terms of truly significant variables, such as growth, development and equity. Buitert, Willem (2003) for example, states that price stability should be seen as a tool for achieving important long-run objectives, such as greater efficiency and long-term growth. The centre of attention of macroeconomic policymaking should be on 'real macroeconomics' and the use of productive capacity—the employment of capital and labour at their highest potential level—and improvements in that productivity.

### 3.0 Stabilization and Growth

Birdsall, Nancy et al (2001) argues that what people truly care about is the stability and growth of their real incomes. It should be obvious why growth is important: even small changes in the rate of growth, say, from 2.5 per cent to 3 per cent, add up significantly over time because of the effect of compounding. With a growth rate of 2.5 per cent, incomes double every 28 years; with a growth rate of 3 per cent, they double every 23 years.

It's the overall stability of output and the real economy, and not just price stability, that concerns firms when they make investment decisions. Levine, Ross et al (1992), states that high instability generates an 'unfriendly' domestic macro-environment that appears to be a crucial factor in explaining low rates of capital formation: firms have less incentive to invest, and growth will be lower. Similarly, economic policies that lead to fuller utilization of resources today may also lead to higher incomes in the future. This implies that there may be less of a trade-off between growth and stability than orthodox economics suggests.

Barro, Robert (1997) indicates that issues of stabilization and growth cannot be separated. In general, the conduct of short-run stabilization policy has long-term effects. If the economy's output is lowered 10 per cent today, the best estimate is that the output path will be 10 per cent lower than it otherwise would have been ten years from now. That means that downturns have long lasting effects. Even Korea and Malaysia, countries that economists regard as having recovered well from the Asian crisis, are moving in a path some 10 points below the trend they set in the pre-crisis decades.

### 4.0 Inflation

Bank of Japan (2003) observes that although mainstream economics has focused on price stability as one of its primary policy objectives, there is considerable confusion as to its role. High inflation is said to signal that the government (fiscal and monetary authorities) is not doing its job well. Inflation is thus a variable that is of concern not in its own right, but as an *indicator* of economic mal-performance. There are, however, two problems with this analysis. First, many people have started to view the indicator as the policy objective itself. Second, the links between inflation and real variables may be weaker than usually assumed.

Bruno, Michael (1995) indicates that all economic policies involve trade-offs, the question here is whether the benefits of further reducing inflation outweigh its costs. Since 1991 most developed and developing countries have experienced low or moderate inflation, with many countries experiencing relatively low inflation. When inflation is low or moderate, efforts to reduce it further may have smaller benefits and increasing costs, especially when traditional contractionary monetary policy is the only instrument used to fight it. As i will discuss below, this may dampen employment in the short-term and growth in the longer-term.

Much of the importance placed on fighting inflation in developing countries like Kenya today stems from the history of *hyperinflation* in several Latin American countries in the 1980s. There were also episodes of very high inflation in some transition economies of central and Eastern Europe in the early 1990s. But countries in Asia have rarely experienced hyperinflation, and the African experiences have been quite different from the Latin American experiences.

According to Bruno, Michael (1995), there is general agreement that hyperinflation has large economic costs, and that defeating it should be a top priority. Hyperinflation, and even high and uncertain inflation, creates huge uncertainty about changes in relative prices, which can be devastating for the information quality of prices and for the efficiency with which resources are used. Behaviour gets distorted as firms and individuals work to spend money quickly, before it diminishes in value. In some countries, huge amounts have been spent on institutional arrangements to protect individuals from the effects of inflation. Under more moderate inflation levels (let's say 15 to 20 per cent), these costs will be much lower.

#### ***4.1 The Impact of Inflation on Growth***

There is little evidence that moderate inflation has a significantly adverse impact on growth. Real growth rates in periods of fairly high inflation have sometimes been impressive—and far better than growth rates in seemingly similar countries that have brought inflation down. Very high inflation and hyperinflation have been generally associated with low growth or open economic recession, although there are exceptions to the rule, as in Israel in 1979-1985.

Bruno, Michael (1995) indicates that *moderate* rates of inflation have been accompanied by rapid economic growth quite often, as in Argentina in 1965-1974, Brazil in 1965-1980, Chile in 1986-1996, and Poland in 1992-1998. The view that low inflation facilitates economic growth is *not* valid as a general proposition. For several of these countries, the periods of low inflation have been among those with the slowest rates of economic growth, such as Argentina in 1994-2001, Brazil in 1996-2003, and Israel in recent years.

Ben-David, Dan et al (1998) observes that unexpected or volatile inflation has been more problematic. The high variability in interest rates associated with volatile inflation can pose a serious problem in economies where firms have borrowed extensively, as was apparent during the Asian crisis. The rise in interest rates led to widespread bankruptcies because firms were carrying large levels of short-term debt that had to be refinanced at extremely high rates. Of course, had there been a history of high volatility of interest rates prior to the crisis, firms probably would not have held so much short term leverage in the first place, and the volatility in inflation would have had far less impact. If firms come to believe that there will be periodic episodes of high interest rates, they will limit their borrowing. But, as explained below, this too can have a significant adverse effect on growth.

Policymakers should, of course, undertake policies that mitigate the effects and facilitate a broad adjustment to ‘shocks’. When governments respond to inflation by tightening macroeconomic policy, while doing little to facilitate the broader adjustment, the country is likely to be worse off, especially when the ‘shock’ has already led to an economic slowdown.

Overall, it seems clear that the inflation threshold differs from country to country; but in general, I can say that the threshold is significantly higher than the extremely low levels advocated in most inflation targeting regimes of the late 1990s and early 2000s. Moderate inflation does not seem particularly bad for growth, and too low inflation (aiming at price stability) may actually be bad for growth.

#### ***4.2 The Costs of Fighting Inflation***

The benefits of maintaining low inflation have to be offset against the costs. The costs of inflation depend, of course, on how inflation is fought. But whatever the specific tools employed, the fight against inflation usually leads to higher unemployment, at least in the short run, and the risk of lower growth in the medium term.

One of the arguments against excessive inflation as stated by Alesina, Alberto et al (1993), is that it impairs the efficiency of the economy, but using tight monetary policy to fight inflation can be equally damaging. In Russia, excessively tight money from 1993 to 1998—defended on the grounds that it was needed to combat inflation—had extremely adverse effects on efficiency to the point that between 60 and 80 per cent of all transactions were conducted by barter. High interest rates used to fight inflation can also cause widespread bankruptcies, especially when an economy is characterized by a significant amount of leverage, as was the case in East Asia.

A heavy reliance on monetary policy to stabilize the economy may also lead to interest rates being highly variable. Both high and excessively variable interest rates make funds more expensive. In developing countries like Kenya, equity markets work poorly, and most outside financing is in the form of debt. If firms are reluctant to take on debt they will have to rely on self-finance, and will find it difficult to meet their working capital needs. Thus high and variable interest rates impair the efficiency of capital markets, further lowering growth rates.

Akerlof, George et al (1993) indicates that sometimes governments address one problem, such as inflation, while exacerbating others. One way to check inflation is to allow the currency to appreciate. This reduces aggregate demand and domestic price pressures at the same time that imported prices in local currencies fall. Even when governments do not deliberately focus on the currency, the exchange rate typically strengthens when the government fights inflation by raising interest rates. While this may reduce inflation, it can have other costs. The strong currency can hurt exports, the sectors that compete with imports, and employment generation. The resulting trade deficit may lead to an external balance problem for the future even worse than the problems that might otherwise have resulted from inflation.

## **5.0 External Balance**

Levine, Ross et al (1992) observes that, like inflation, external balance is an intermediate variable, less important in its own right, and more important for its impact on variables that are of greater concern, such as stability and growth. It is not always easy to evaluate the links between external balance and the more fundamental objectives (just as it's difficult to evaluate the links between inflation and the fundamental objectives). Countries generally try to maintain rough external balance—but what this means is not always clear. Some countries, like the United States, have maintained large trade deficits for a long time, without a serious problem. Others seem to face a problem after only a short period of a relatively moderate trade deficit.

Frenkel, Roberto (2004) observes that. in the world of fixed exchange rates that prevailed before the early 1970s, a country that was buying more from abroad than it was selling had to pay for the gap, either by borrowing abroad or selling international reserves. Eventually, a country's reserves would run out, and its creditors would no longer be willing to lend, leading to a crisis. With flexible exchange rates, the sequence is slightly different, but the outcome is not dissimilar. If the country seems to be borrowing excessively, lenders and other investors may suddenly lose confidence in the country and want their money back. The exchange rate plunges as investors try to take money out of the country, making it even more difficult for those in the country to repay dollar-denominated short-term debt.

Borrowing from abroad has both short-term and long-term consequences, but the nature of those consequences depends on what gives rise to the borrowing. If countries borrow to finance productive investments that will generate returns in excess of the interest rate charged, then growth will be enhanced. Investors will recognize the economy's increased strength and should have more confidence in it. But, by borrowing abroad, the country is taking on foreign currency risk, so that a devaluation of the local currency will raise the amount of external debt relative to domestic GDP.

Dodd, Randall et al (2005) states that frequently, however, capital inflows (especially short-term inflows) go to finance increased consumption. Then foreign investors might be justifiably worried about the country's ability to repay its debts. A lack of external balance might then be heralding a crisis that will have enormous costs to society. Argentina, for example, experienced zero inflation and a strong consumption-led recovery in 1996-1997 fuelled by capital inflows. GDP growth averaged over 6.7 per cent per year. But the current account deficit as a per cent of GDP nearly doubled, and unemployment remained high. The recovery was then followed by a four-year recession (1999-2002), during which GDP fell 18 per cent and unemployment rose.

## **6.0 Unemployment and Poverty**

Frenkel, Roberto (2004) notes that one central objective of macroeconomic policy should be to maintain the economy as close to full employment, or full utilization of the labour



force, as possible. Economists consider some unemployment necessary since it takes time for workers to move from one job to another, but significant underutilization of a country's capacity obviously represents a great waste of resources. One problem policy makers face is at what level they should start to be concerned with unemployment. As we discuss later, there is generally a trade-off between unemployment and inflation. The question that economists usually ask is how low the unemployment rate can go without setting off inflationary pressures. (A similar question could probably be asked in relation to underemployment in developing countries like Kenya, but this has not been subject to systematic research).

Jorgenson, Dale et al (2001) observes that unemployment and underemployment are two of the most important sources of poverty and inequality; without a job, individuals in most developing countries are condemned to a life of poverty and exclusion. Unemployment also weakens workers' bargaining position, thereby lowering wages and further increasing inequity. There are, of course, also huge social costs of unemployment. But there are further reasons why unemployment may have a particularly strong impact on poverty and inequality.

First, high unemployment typically hurts the least skilled people the most. There is a 'job ladder', with the most skilled taking jobs from the less skilled in times of a job shortage. That is why the unskilled are most likely to experience bouts of unemployment. Second, high unemployment pushes down wages, and this increases inequality even more. Third, in many countries, especially developing countries, unemployment insurance is non-existent or woefully inadequate, and most workers have only a small buffer of savings. Hence, after an extended period of unemployment, savings are consumed, and individuals generally lose any assets that have been collateralized.

It is clear that two key objectives—maintaining low unemployment and underemployment and reducing poverty—typically complement one another. By the same token, some policies that promote growth also help to reduce poverty. But other policies might promote growth without reducing poverty or promote stability without stimulating growth. There are important trade-offs, especially when policymakers focus on intermediate variables. In the next section, we look at the main macroeconomic policy tools, the trade-offs associated with them, and their use in achieving long-term and short-term economic objectives.

## **7.0 Fiscal and Monetary Policies**

Gaspar, Vitor et al (2002) states that the three standard macroeconomic policy instruments that governments use to stabilize the macro-economy are fiscal, monetary, and exchange rate policies. Yet there are debates on the efficacy of each of these instruments. For example, some economists argue that fiscal and monetary policies are ineffective in all countries. Others argue that they are important policy tools, though their effectiveness depends on conditions in the economy. In addition how policies are pursued is important: different instruments have different implications for effectiveness, equity, development, and growth.

Discussions of policy instruments are often further confused because governments have limited ability to pursue one policy independently of the others. For example, under a fixed exchange rate system, the exchange rate chosen by the government might not be sustainable, given the chosen fiscal and monetary policies. This is especially true with open capital markets, since monetary or fiscal policy choices can cause capital to leave or enter the country, putting pressure on the fixed exchange rate. I also discuss the importance of policy coordination and how this affects basic policy choices, including the institutional framework for policymaking.

## **7.1 Fiscal Policy**

Marfán, Manuel (2005) observes that much of the fiscal policy debate has come to focus on the need for developing countries to maintain tight fiscal policy. One widespread view is that fiscal deficits should be avoided because they ‘crowd out’ private investment, can lead to a loss of investor confidence, and are inflationary. Standard Keynesian economics, on the other hand, emphasizes that fiscal policy is an effective tool for stimulating an economy facing an economic slowdown.

Yet, even those who believe in the efficacy of fiscal policy in developed countries recognize that developing countries face significant impediments to relying on fiscal policy during economic downturns (which is when they should engage in deficit spending). Many governments like those in Kenya and Tanzania find it difficult or expensive to borrow the funds necessary to finance government spending, while countries that are able to borrow risk running up excessive debt burdens that could be difficult to repay in the future – especially when the funds are not well invested.

### ***7.1.1 Sources of Fiscal Revenues and Policy Constraints***

#### *Borrowing Constraints*

Fernández de Lis et al (2001) notes that one of the main reasons the IMF was founded in 1944 was to help countries in depressed conditions finance deficits for economic expansion. The founders recognized the interdependence of nations, which means that a downturn in one country can have adverse effects on others. They also recognized that capital markets are imperfect, and some countries, especially those that are heavily indebted and need funds the most, are sometimes unable to borrow at all. The modern theory of capital markets, with asymmetric information and costly enforcement, explains why such credit rationing can occur. When it does, countries are forced to engage in procyclical fiscal policy: they are forced to cut their deficits during economic slowdowns, exacerbating the recession.

#### *Aid Delivery and Absorption*

Since the Millennium Development Goals (MDGs) were agreed by the UN General Assembly in 2000 and the Monterrey consensus on Financing for Development in 2002,

efforts have been underway to muster support to increase development assistance to 0.7 per cent of developed country national income. In addition, the change in aid modalities has moved towards more direct budget support. The new environment poses challenges for both aid donors and recipients. Most people would naturally expect that an increase in aid would lead to an increase in spending. What few realize is that this is only one half of the equation—aid really only benefits the recipient economy when it is absorbed. In the best of times, coordination is needed between officials in the Ministry of Finance and the Central Bank. With budgetary support, this cooperation is of paramount importance.

Aid financing is like other foreign inflows: it impacts exchange rates, interest rates, and domestic prices, as we discuss later in this note. The injections of liquidity, through the conversion of donor flows into domestic currency, can cause gyrations in interest and exchange rates, especially when flows are volatile. Donor flows may produce exchange-rate appreciation and, if sustained over a length of time, could lead to the kind of overvaluation phenomenon known as ‘Dutch disease’, which we discuss later, following the section on exchange rate policies.

Ocampo, J.A. (2002) states that predictability of aid flows over time is a precondition for their effective use. But aid flows, like other capital flows, tend to rise and fall with economic cycles in donor countries and policy assessments of the recipient countries, as well as shifts in donor policies. This volatility is exacerbated by the gap between commitments and disbursements. Empirical work suggests that the volatility of aid flows exceeds that of other macroeconomic variables, such as GDP or fiscal revenue. Moreover, donors tend to move in and out together, causing herding behaviour. The PRSP function like a rating signal for donors, and they react in a similar fashion to signals by Bretton Wood institutions – in many ways, similar to the reactions of private creditors. When aid falls; it leads to costly fiscal adjustments in the form of increased taxation and spending cuts that reinforce the cyclical impact of declining aid flows. Similar to other capital flows, the volatility of aid flows also affects the balance sheets of the banking system and credit availability.

Policymakers need to look at the longer term as well, and answer some hard questions as they make decisions. If one expands public sector investment now, using aid, will the government be able to maintain that level of spending in the future, when the aid flows begin to slow? If not, is the initial spending wasted? Countries like Kenya and other developing nations need to design policies to reduce aid dependency by maintaining and increasing domestic revenues in a sustainable fashion.

### *Public Resource Mobilization*

Tanzi, Vito et al (2001) notes that the most effective way to fund government spending and reduce aid dependency is to mobilize domestic resources. The low levels of tax collection in many poor countries limits important government expenditures and forces countries to borrow or depend on aid flows to finance basic development needs. Given the volatility of external financing and the important role that public sector investment can play in long-term development, it is critical for governments to be able to raise domestic

revenues. Only with increased tax revenues will countries be able to sustain long-term domestic investments and fiscal policy flexibility.

Martner, Ricardo et al (2003) observes that poor countries, on average, collect only around about two-thirds of the tax revenues as a percentage of GDP collected by richer countries. Even some of the wealthier emerging market countries, such as India, still have relatively low tax revenue to GDP. In most developing countries direct taxes, such as income taxes, contribute only a small percentage of total tax revenues. For example, tax collection on income, profits, and capital gains in Latin America and Asia is one-third to one-half of collection levels in OECD countries.

Auerbach, Alan (1991) notes that most developing countries rely on indirect taxes for revenue. Many of the reforms of the 1990s and 2000s, which pushed an agenda of liberalization, shifted taxation to VAT from other indirect taxes, such as tariffs and other trade taxes. VAT is a tax on consumption, rather than investment, and many orthodox economists supported the shift to VAT because they believed it would distort incentives to invest less than other types of taxes. Yet VAT is also a tax on the formal sector. It is therefore not as effective in countries with large informal sectors. In these countries VAT operates like a tax on sales rather than a tax on value added. In fact, VAT can encourage firms to stay in the informal sector to avoid taxation, hindering the development of the formal sector. VAT is also a regressive tax, meaning that the poor pay more as a share of income than the wealthy.

Although the WTO has limited the ability to use trade taxes, there is still some scope within the WTO for some use of trade taxes as well. For example, taxes can target luxury items that are imported; or a system of variable tariffs on agricultural and industrial goods can operate in a band within the WTO tariff bindings. (These and other trade-related taxes are discussed in the Trade Policy Note in more detail.) Countries can also impose export duties to capture some of the gains from devaluation. Argentina, for example, imposed export duties that generated revenues of almost 2.5 per cent of GDP following the devaluation of the peso in 2001.

Martner, Ricardo et al (2003) states that to reduce evasion, countries can also try to design more 'corruption-resistant tax structures' that rely on non-discretionary and readily observable tax instruments. One such measure is a tax on financial transaction. Countries such as Argentina, Brazil, India, and Korea imposed this type of a tax on bank debits. In Brazil, for example, the financial transaction tax collects around 1.5 per cent of GDP. These taxes have the added benefit of providing information about firm transactions that can help authorities increase collection and find evading firms. Korea has also implemented a similar program to reduce the attractiveness of cash by offering a subsidy for credit cards. The goal is to shift transactions from cash to a medium that is traceable. These types of taxes generally carry the risk that they might encourage firms to operate outside the formal banking sector, but in countries where banking services are relatively well developed, these taxes have proved to be effective. Furthermore, they play a countercyclical role by slowing financial transactions during financial booms and bubbles.

### 7.1.2 The Effectiveness of Fiscal Policy

I now turn the focus to the effectiveness of fiscal policy. Assuming countries can borrow: is fiscal policy generally effective – or should it be avoided because it adds to inflationary pressures and crowds out private investment? Later in this note I will discuss low-cost stimuli and other fiscal measures that countries with limited ability to borrow can use to stimulate the economy.

Mahadeva, Lavan et al (2000) observes that in Keynesian analysis, government expenditures (or tax cuts) lead to an increase in GDP that's a *multiple* of the original expenditure. Most of the money paid by the government is re-spent, and the more that's re-spent, the greater the multiplier. If savings rates are low, as they often are in very poor countries, then the proportion of funds going into consumption will be high, the multiplier will be very large, and public expenditures will be particularly effective. By contrast, in East Asia, where savings rates have been very high, multipliers have been somewhat smaller.

When households and firms are credit and cash constrained (as there often are in developing countries), the multiplier can be even stronger: if those households and firms had more money they would spend it. For example, if the government provides better unemployment benefits, it's likely that the unemployed will spend all or almost all of the benefit. When they spend the money, some of it will go to individuals (landlords, storeowners, etc.) who will not spend all of it, but the important point is that in developing countries the multiplier can be quite high.

McKinley, Terry (2005) notes that it's important to differentiate between the effects of deficits when the economy is in recession and when the economy is at full employment; the latter case is when deficits are more likely to have an adverse effect. Crowding-out (and inflationary) arguments are then persuasive because the size of the 'pie' is fixed. When the economy is operating at capacity, increased government expenditures must come at the expense of reduced consumption or reduced investment somewhere else in the economy. But crowding out is *not* inevitable when the economy is *below* full employment. The size of the pie can increase so that government expenditures can rise without private investment decreasing. Or, in the case of tax cuts, consumption can increase, without investment decreasing.

Finally, private sector responses may actually have the opposite effect – and enhance the effects of fiscal policy. There may be 'crowding in'. For instance, higher government expenditures might stimulate the economy and improve the economic situation so much that there's room for more investment. Similarly, an increase in government investments that complements private investment (for example, spending on infrastructure) can increase returns in the private sector and stimulate private investment and the economy as a whole.

FitzGerald, Valpy (2006) argues that the success of China's expenditures during the East Asian crisis provides a case in point. Part of the reason for China's success was that

current expenditures drew upon a set of strategic investment plans that focused on improving infrastructure. The improved infrastructure increased the returns to private investments. This, in turn, encouraged productive investments that stimulated China's long-term growth. India's experience with stabilization and adjustment, following its external debt crisis during the early 1990s, was somewhat different. Yet, it also provides clear evidence of complementarities between public investment and private investment, which suggests crowding-in rather than crowding-out.

### ***7.1.3 Alternative Fiscal Policy Measures***

#### *Fiscal Policy Accounting: Structural and Primary Deficits*

Svensson, Lars (2000) observes that a primary aim of economic policy in developing countries like Kenya should be to avoid the procyclical bias in fiscal policy. This can be consistent with the establishment of rules that guarantee long-term sustainability of the fiscal account, such as targets for the public sector deficit and/or maximum debt-to-GDP ratios. (The definition of such rules is not an easy task, however, as demonstrated by the recent debates over the European Stability and Growth Pact.)

Schneider, Benu (2006) observes that in particular, a focus on the *current* fiscal deficit (measured during the recession) is clearly inappropriate. Rather, it's essential to estimate 'the *structural* deficit', which evaluates what the budget would be without cyclical fluctuations in a 'normal' (full employment) situation. For example, when tax revenues fall during a recession, the current fiscal deficit will worsen, but the structural full employment deficit will not be affected, and the government will not be forced to tighten fiscal policy further to meet its deficit target. If necessary, the institutions could play a role in financing any *current* fiscal deficit that arises. To the extent that cyclical swings reduce the efficiency of public sector spending, it may make sense to determine structural targets on the basis of an essentially long-term criterion: the balanced supply of public and private goods.

#### *Management of Public-private Partnerships*

Zahler, Roberto (2003) notes that deficit targets should be complemented by adequate mechanisms to manage public-sector guarantees. Deficit targets create a strong incentive for governments to promote private (rather than public) sector investment in infrastructure to circumvent the targets, even when there is no economic reason to do so. A major problem in relation to these guarantees is that they generate significant distortions in public sector accounting. The contingency costs of such projects for the state are not usually accounted for, and do not show up in current expenditures. Such guarantees imply that the government acts as an insurer of risks that the private investor might incur. The 'insurance premium equivalent' of such guarantees should be regularly estimated and budgeted, with the corresponding resources transferred to special funds created to serve as a backup in the event that the corresponding contingencies become effective. The estimated contingent liabilities should also be added to the public sector debt.

### *Automatic Stabilizers: Fiscal Stabilization Funds*

Due to the inevitable time lags in the decision making process, *automatic* stabilizers may sometimes be preferable to discretionary changes. Progressive taxation, which reduces the impact of taxation on the poor during a recession, is one such stabilizer. (The shift toward V.A.T., has moved countries away from progressive taxation, which may lead to the tax system being a less effective automatic stabilizer.) Well-designed social safety nets that protect vulnerable groups during crises, preferably as part of permanent social protection systems, and fiscal stabilization funds are other important instruments in this regard.

Fiscal stabilization funds, which sterilize temporary public-sector revenues, should be a central tool for countercyclical policy. The experience gained from the management of stabilization funds for commodities that have a significant fiscal impact (the National Coffee Fund of Colombia, the copper and petroleum funds in Chile and the oil funds in several countries) can be extended to develop broader fiscal stabilization funds. A similar example is foreign exchange reserves, which provide 'self-insurance' against sudden interruptions in external financing (as well as reduced currency appreciation).

## **7.2 Monetary Policy**

Orthodox economists, for the most part, believe that monetary policy is relatively ineffective. In this school of thought, the economy normally operates close to full employment (a condition clearly not applicable to most developing countries), so that any increase in aggregate demand cannot increase output; it can only push up prices. On the other hand, Keynesians believe monetary policy is an important tool in macroeconomic management.

### ***7.2.1 The Effectiveness of Monetary Policy***

Zahler, Roberto (2003) notes that recent experiences confirm both the strengths and limitations of monetary policy. In general, economists view monetary policy as more effective in restraining an overheated economy than in expanding an economy in deep recession. Monetary policy, for example, has not been effective in stimulating growth in countries experiencing deflation (such as Japan). In the United States, lowering interest rates from 2001 to 2003 did little to stimulate investment, but did induce households to refinance their mortgages. The reduced mortgage payments and the improved financial position of households enabled consumers to sustain their spending even as their stock market wealth diminished enormously.

Shapiro, Carl et al (1984) observes that the impact of monetary policy in developing countries is likely to differ from the impact in the United States and other advanced industrial countries. Monetary policy has its most direct impact through the banking system. In countries with more developed banking sectors the effects of monetary policy can be more significant in developing countries than in developed countries since firms

have less access to nonbank sources of finance and tend to rely more on bank lending. In many least developed countries, though, the banking sector is extremely undeveloped, and most firms rely on self-finance. In these circumstances, the impact of monetary policy on the economy is limited. The narrower the impact of monetary policy, the greater the costs associated with using it, since a few sectors are forced to bear the brunt of adjustment. Those sectors may face greater volatility, as interest rates rise and fall in an attempt to stabilize the economy.

Under conventional closed economy analysis, lowering interest rates leads to increased investment and higher growth. Recent research points to additional channels through which changes in interest rates either reinforce or counteract the conventional effects. First, there are several channels through which lowering interest rates may stimulate consumption further than the conventional analysis implies. Changes in the interest rate represent a redistribution of income between creditors to debtors. Distribution matters: debtors may have a higher marginal propensity to consume than creditors. If firms and households are credit constrained, lowering interest rates may mean that firms will have more money for investment and households will have more money for consumption. In addition, there may be wealth, or balance sheet effects. The value of assets such as stocks and real estate increases with lower interest rates; and the increased wealth may induce households to consume more.

On the other hand, recent research also suggests additional reasons why monetary policy might be *ineffective*. In particular, Greenwald and Stiglitz (2000) emphasize that *credit*, and not the money supply, matters for the level of economic activity. The banking system is central in determining the supply of credit. Even if the interest rate on treasury bills falls, banks may be reluctant to lend more when they believe their balance sheets are weak, or when they perceive the risk of lending to be very high (and therefore, can achieve high, safer returns by lending to the government). This is further complicated in an open economy by the impact of capital flows. Standard Keynesian analysis does not explicitly deal with capital inflows. To the extent that it does, it assumes that their effects can be fully sterilized through monetary policy. But this analysis overlooks the impact of capital flows on the supply of credit. Capital flows affect the resources available to households and firms, and even affect the lending activity of banks.

One reason why it is difficult to disentangle the effects of monetary policy on an open economy, particularly one with flexible exchange rates, is that the impact on capital flows is hard to predict. The general view is that, *other things being equal*, an increase in a country's real income generated by expansionary macroeconomic policies is likely to induce capital inflows. So too, *other things being equal*, an increase in the interest rate – associated with, say, a contractionary monetary policy – will induce capital inflows and lead to an exchange rate appreciation (and, alternatively, a lower interest rate will result in capital outflows, and a weaker exchange rate). But other things are never equal, particularly due to the complex interaction between interest rates and capital flows.

Reinhart, Carmen et al (2004) notes that in an open economy, lower interest rates can lead to capital outflows and a weaker exchange rate. This, combined with the weakened balance



sheets that often result from exchange rate devaluations, may limit credit availability, and could attenuate, or even reverse, the normal impact of lower interest rates on aggregate demand. Any attempt by policymakers to counteract the drop in demand by lowering interest rates further will be partially self-defeating, as the lower interest rates will induce even more capital outflows. *In other words, open capital markets limit the effectiveness of monetary policy.*

Kaminsky, Graciela et al (2004) states that higher interest rates may attract capital inflows, increasing the credit supply and leading to higher investment, limiting or reversing the usual effect. In addition, there are two medium-term effects of raising rates. First, when the central bank raises rates, it usually raises short term rates, attracting short term speculative capital. These flows often go into consumption or real estate, rather than into long-term productive investment. The implication is that the short-term boom is exacerbated, without a long-term positive impact on growth. Second, the increased inflows also lead to currency appreciation. This can slow the economy in the medium to long term as export and import-substitution industries become less competitive. The capital inflows can lead to changes in the structure of production that stymie medium to long term growth, while the higher rates do little to limit the short-term bubble.

#### *Indirect Monetary Policy Instruments*

Standard indirect interventions include open-market operations, changes in reserve requirements, and central bank lending facilities. Most developed countries use *open market operations* as their main monetary policy tool. Open market operations are most effective when countries have relatively developed and liquid capital markets.

Ffrench-Davis, Ricardo et al (2003) observes that some countries have gotten around this by issuing Treasury Bills in the primary market through auctions. The quantity of new bills issued, net of the amount of maturing bills, has the effect of increasing or decreasing the money supply, similar to open market operations. Nonetheless, when markets are underdeveloped or illiquid, the price signal is generally not efficient, and this method is usually supplemented by additional mechanisms.

A second monetary tool is the *discount rate*. The discount rate is the interest rate the central bank charges commercial banks for loans, which are usually short-term in nature. Some central banks use the discount rate as a signal; for others, especially those with less developed markets in which open market operations are not very effective, it is the main instrument of monetary policy. The central bank can also use the discount window to act as a lender of last resort during liquidity shortages. A third method for managing the money supply is through *reserve requirements*. Reserve requirement stipulates that banks hold a percentage of their total reserves with the central bank. Reserve requirements are generally not used significantly as monetary policy tools in most industrialized countries. However, reserve requirements can be a useful instrument, especially when targeted to specific sectors, as discussed below under 'direct mechanisms'.

#### *Direct Mechanisms and Other Microeconomic Measures*

Goodfriend, Marvin et al (2001) notes that monetary policy is a blunt tool: raising interest rates affects all sectors of the economy, those experiencing bubbles, as well as those experiencing fragile recoveries or still in recession. Rather than relying on interest rates, authorities can use other measures to target specific sectors of the economy. In this regard, there are three issues that are particularly important for developing countries: how to target bubbles; ways to encourage credit when constraints are specific to certain sectors of the economy; and ways to encourage bank lending when credit constraints are more general.

Direct measures can be extremely useful in developing countries like Kenya that want to maintain economic growth, but worry about excessive investment in a particular sector. When bubbles exist, central banks can raise reserve requirements on loans to the sectors affected, such as real estate or equity markets. This mechanism could have been effective at limiting some of the build-up in bubbles prior to the Asian crisis.

Gordon, Roger et al (2005) observes that when the banking system is inefficient, these measures can be particularly useful. Whereas indirect instruments generally require a well-developed money market, direct measures are relatively easy to implement. Many developing countries are in a position where administrative controls still work fairly well—far more effectively than traditional channels of monetary policy. The administrative measures China employed in 2004 and 2005, for example, seem to have been relatively effective in curtailing the real estate boom. Had the government relied on interest rate increases, it would have squelched investments in factories and other job creation at the same time (or even before) it had tamed the speculative boom.

When credit rationing exists, as it does in most developing countries, what is relevant is not loan demand, but loan supply; authorities need to implement policies to induce banks to increase lending. For example, changing regulatory policies, such as capital adequacy requirements and other banking regulations, can impact credit availability. When inflation is due to supply shortages in sectors of the economy experiencing credit constraints, authorities can look to innovative ways to ensure that credit reaches these sectors, rather than raising interest rates and slowing the economy as a whole. Development banks are one tool that can help direct credit to areas in need. Recent research has focused on isolating market failures and constraints on growth and on using market mechanisms, rather than discretion, to determine those sectors in need.<sup>44</sup>

### ***7.2.2 The Macroeconomic Dimensions of Prudential Regulations***

Gordon, Roger et al (2005) observes that changes in banking regulations have more macroeconomic implications than is usually accepted (their effects tend to be ignored in most macroeconomic analysis). Banks use microeconomic risk management to reduce the risks associated with the individual characteristics of borrowers, and prudential regulations have been designed to encourage banks to manage these risks. But it is more difficult to reduce risks associated with the common factors that all market agents face, such as the effects of macroeconomic policies and the business cycle. In recent years,

increasing attention has been placed on risks that have a clear *macroeconomic* origin, and ways to use prudential regulations as a tool for macroeconomic policy. Traditional regulatory tools, including both Basle I and Basle II standards, have a procyclical bias. In these systems, banks have to provision capital against loan delinquency or short-term expectations of future loan losses. Since expectations of losses are low during economic expansions, these systems are not effective in hampering excessive risk-taking during booms.

The Spanish system of forward-looking provisions, introduced in December 1999, is a major policy innovation in addressing the pro-cyclical elements of prudential regulation. According to this system, provisions are made when loans are *disbursed* based on *expected* (or 'latent') losses. Such 'latent' risks are estimated on the basis of a full business cycle, and are not based on the current economic environment. This system implies that provisioning follows the criteria that are traditionally used by the insurance industry (where provisions are made when the insurance policy is issued) rather than by the banking industry (where they are made when loan payments come due).

## **8.0 Microeconomic Measures**

In addition to direct management of the exchange rate, microeconomic interventions can be used to impact relative prices. For example, microeconomic policies can be used to change the composition of demand towards non-tradables and away from imports. Tax policies that encourage more spending on domestically produced goods and less on goods produced abroad will help to stimulate the economy, and at the same time, strengthen the currency. In many developing countries, most luxury consumption goods are imported. A high sales tax on such goods discourages these imports. Government expenditures can also be weighted towards domestically produced goods.

## **9.0 Monetary and Exchange Rate Policy Rules and Institutional Design**

Lance Taylor (2006) notes that the choice of exchange rate regime is closely related to the broader question of what monetary policy rules the central bank should follow, and the institutional design of the central bank itself. There are three distinct but related questions: whether the central bank should follow monetary policy rules, such as fixing the currency or inflation targeting, or whether it should follow discretionary policies; whether the mandate of the central bank should focus on inflation or whether it should include other policy variables, such as growth and employment; and whether the central bank should be independent.

### ***9.1 Rules vs. Discretion and Inflation Targeting vs. Foreign Exchange Targeting***

In the 1980s, the most favoured rule prescribed expanding the money supply at a constant rate. Then, it became clear that the demand function for money was unstable and hard to predict, especially in developing countries, and the money supply rule lost favour. Many developing countries chose to target the exchange rate since it was viewed as a simple and transparent indicator. But the exchange rate crises in the mid to late 1990s led to a

shift to flexible exchange rate regimes, and today, inflation targeting<sup>61</sup> is the preferred monetary rule.

On the other hand, Keynesian economists generally believe that central bankers should be allowed to use more discretion than allowed by strict rules. Because strict inflation targeting rules do not distinguish between inflation fuelled by expectations and inflation fuelled by VAT increases or external shocks (such as oil price rises or exchange rate devaluations) it can lead to procyclical policies. For example, inflation targeting can lead to exchange rate targeting or contractionary monetary policies during periods of devaluations, counteracting the exchange rate effect on competitiveness. Inflation targeting often incorporates two widely used procyclical policies: anchoring the price level to a fixed exchange rate during periods of foreign exchange inflows and counterbalancing the inflationary effects of devaluation with contractionary monetary policies during periods of outflows. Strict inflation targeting can therefore generate more output volatility than monetary policy goals that take into account other objectives such as reducing the output gap.

J.A. Ocampo et al (2006) notes that a second issue to consider in choosing monetary regimes is the efficiency or stability of the inflation-targeting rule. This is more complicated than can be addressed in this note, but we will discuss it briefly. It concerns, for instance, the extent to which (and the circumstances under which) conventionally measured changes in inflation provide a good indicator of whether employment is above or below the full employment level. There is, in addition, a more fundamental question surrounding inflation targeting: whether a policy structure – in which monetary authorities focus on inflation and fiscal authorities focus, for instance, on external balance – is a good way of achieving the ultimate objective of full employment with external balance.

Under inflation targeting, the government or monetary authority announces a target for the inflation rate, and the monetary authorities commit to achieve this target. Inflation targeting divides responsibilities between government and a monetary authority, so that each policymaker focuses on a single objective. The problem is that dividing responsibilities reduces coordination.

## ***9.2 Central Bank Mandate***

Budnevich, Carlos et al (1997) notes that many countries have narrowed the mandate of the central bank to fighting inflation. In the United States, however, the Federal's Reserve mandate is not only to ensure price stability, but also to promote growth and full employment. A Bank of England Survey of 94 Central Banks found that only 26 per cent had monetary stability as their only objective; 70 per cent had monetary stability combined with other goals; 3 per cent had no statutory goals; 1 per cent had only non-monetary stability as its goal.

There is some evidence that independent central banks with an inflation target do achieve lower levels of inflation—it would be striking if they didn't. But inflation is only an intermediate variable. The significant question is whether economies with this

institutional structure achieve better performance in real terms: growth, unemployment, poverty, equality. There is little evidence that independent central banks focusing exclusively on price stability do better in these crucial respects.

Central banks make decisions that affect every aspect of society, including rates of economic growth and unemployment. Because there are tradeoffs, these decisions can only be made as part of a political process, as discussed in the next section.

### ***9.3 An Independent Central Bank***

An independent central bank has become accepted as the most appropriate institutional arrangement to separate macroeconomic policymaking from the political process. There are, however, two main criticisms of this approach. The first criticism is that the arrangement can undermine democratic governance. Citizens consider few issues more important than the quality of macroeconomic management. By delegating authority over the economy to an independent central bank, the government is being held accountable for something over which it does not have authority. Moreover, we have seen that macroeconomic management entails trade-offs, with different decisions affecting the well-being of different groups. Such decisions are necessarily political. Delegating them to technocrats who are ‘independent’ from the government undermines democratic accountability.

While economists and politicians have long discussed the desirability of independent central banks, they have spent much less time considering the importance of *representativeness* (or lack thereof) of these banks. The two concepts are distinct. The problem in many countries is that the governing body of the central bank is typically not representative of society and its broader interests.

Cobham, Alex (2005) notes that governments more sensitive to democratic processes argue that they, and not the central bank, should set targets, such as an inflation target, because the decision involves trade-offs, such as the trade-off between unemployment and inflation. But even a government specified inflation target does not depoliticize the conduct of monetary policy. The central bank is responsible for reaching the target, and missing it still can have costs that not everyone in society bears equally.

## **10.0 Capital Market Interventions and Other Policy Options for Open Economies**

So far, in this note, i have focused on fiscal, monetary and exchange rate policies. I have also presented several heterodox measures as alternatives or enhancements to these. One of the most important set of economic tools available to policymakers is capital account controls and regulations. In this section, i will consider some additional microeconomic tools for macroeconomic management, focusing on capital market interventions.

## **11.0 Interventions in Capital Markets**

In the face of market failures in financial markets, pro-cyclical capital flows and limited room to manoeuvre for macroeconomic policy, capital market interventions can be used to serve multiple purposes. First, they can stabilize short-term volatile capital flows. Second, they can give policymakers additional instruments that allow them more effective and less costly macroeconomic stabilization measures. Third, effective capital account regulations can promote growth by reducing the volatility of financing and the volatility of real macroeconomic performance. Finally, they can also discourage long-term capital outflows. Of all the objectives of intervention listed, discouraging long-term capital outflows is perhaps the most difficult. Yet interventions can be effective, even if controls are partially circumvented. The most critical issue today is not whether market interventions are desirable in theory, but whether, in practice, policymakers can design interventions whose benefit to an economy outweigh the ancillary costs.

### ***11.1 Price and Quantity Based Controls on Inflows and Outflows***

There are different types of capital account regulations. Capital controls include quantity and price-based regulations, both of which can be administered on either inflows or outflows. In addition, some countries use indirect regulations, such as prudential regulations on financial institutions or regulations on investments of pension funds, which have implications for capital flows. Thus, a broader concept of capital account restrictions is useful to understand the complementary use of, and overlap among, different forms of regulation.

Davis, Jeffrey et al (2003) observes that traditional quantity-based capital restrictions (administrative restrictions and controls) continue to be widely used by developing countries, including key countries such as China and India, despite the gradual liberalization of their capital accounts. These regulations are used to target either inflows or outflows on domestic or foreign residents. Regulations that affect domestic residents include restrictions on currency mismatches (only companies with foreign exchange revenues can borrow abroad), end-use limitations (borrowing abroad is allowed only for investment and foreign trade), minimum maturities for borrowing abroad, limitations on the type of agents that can raise funds abroad through ADRs and similar instruments, prohibition on borrowing in foreign currencies by non-corporate residents and, in some countries, overall quantitative ceilings. Limitations on non-residents include restrictions or a prohibition on their capacity to borrow in the domestic markets, direct regulations of portfolio flows (including explicit approval and limitations on the assets in which they can invest), sectoral restrictions on FDI, and minimum stay periods.

Easterly, William et al (2003) observes that economists have a strong proclivity for price-based as opposed to quantity-based interventions. Price-based interventions are flexible, non-discretionary and thus less susceptible to bureaucratic manipulation, and in line with market incentives. But the case for price-based interventions is far from clear. Theoretical work in economics has shown that sometimes quantity-based restrictions can reduce risk more effectively than price interventions.

Most economists also prefer regulating inflows to outflows. There are several reasons for this. First, regulating inflows helps prevent crises, which should be the ultimate goal of policymaking. Second, regulating inflows involves less uncertainty and more transparency: creditors know the cost of regulations before they invest. But, again, the arguments against regulating outflows are not clear-cut. For example, restrictions on outflows may be the only way to solve a collective action problem or coordination market failure. When markets exhibit herding behaviour (and creditors and investors pull their funds out of a country during a crisis because they are afraid that others will pull their funds out first), restrictions on outflows may be the only instrument available to avoid a downward recessionary spiral. Markets generally overshoot in these circumstances, so the restrictions are welfare enhancing.

The empirical evidence shows that all types of instruments can have positive effects, depending on the circumstances under which each mechanism is applied. Policymakers in China, India and Malaysia were able to use quantitative capital account regulations to achieve critical macroeconomic objectives, including prevention of maturity mismatches, attraction of favoured forms of foreign investment, reduction in overall financial fragility, and insulation from speculative pressures and contagion effects of financial crises – leading to greater economic policy autonomy.

### ***11.2 Soft Controls: Encouraging Market Segmentation***

Emran, Shahe et al (2005) notes that soft controls can require domestic funds, such as social security or pension funds, to invest their assets in domestic markets and can prohibit or limit investment abroad. These restrictions reduce the funds' potential to generate pro-cyclical disturbances. Soft controls have an additional positive effect of creating a local demand for domestic securities and helping to develop the local capital markets, and build a domestic capital base.

This kind of control might become particularly relevant in the future because of the growth of privately managed pension funds in many developing countries, especially in Latin America. In Chile (the pioneer in this area), such funds are equivalent to 70 per cent of annual GDP. Most countries place limits on the extent to which domestic funds can invest abroad, and have experienced new sustained growth in domestic markets, in large part because of the increased demand for local securities from domestic pension funds. Once again, the Chilean experience demonstrates the stimulating role of pension funds on the development of domestic capital markets. But it also demonstrates how pension funds can generate macro-instability when the markets are not segmented and funds are allowed to invest abroad.

## **12.0 Public-Sector Liability Management in Developing Countries**

If domestic debt markets are thin, governments might be tempted to finance expansionary fiscal policies through borrowing abroad. But this exposes them to greater future risk as a result of exchange rate changes, and undermines the role of exchange rate changes as part

of the adjustment process. One of the reasons that the countries of East Asia did so well for so long is that their high savings rate enabled governments to invest at a high rate without borrowing from abroad.

*The Economist* (2003) states that if foreign capital markets were well functioning, developing countries would be able to borrow abroad in their own currency (or in a market basket of currencies highly correlated with their own currency). Well functioning markets would enable the transfer of exchange rate risks to developing country lenders who can bear the risk more easily.<sup>78</sup> There have been a few instances in which this happened, but by and large developing countries have to bear the brunt of the risk of exchange rate and interest rate fluctuations. What matters is not so much the source of the funds, but the risk associated with the debt, and given that foreign borrowing entails the imposition of these high risks, countries should limit their exposure.

Baunsgaard, Thomas et al (2005) notes that although the fact that government revenues are largely related to domestic prices suggests that governments should borrow in their domestic currency, there are two reasons why this rule should not be strictly followed. The first has to do with macroeconomic management. The government should manage its external public sector debt to compensate for the highly procyclical pattern of external private capital flows. For example, during phases of reduced private capital flows, the public sector can be one of the best net suppliers of foreign exchange, thanks to its preferential access to external credit, including credit from multilateral financial institutions.

The second reason relates to the depth of domestic bond markets, which determines the ability to issue longer-term domestic debt securities. Well functioning markets require the existence of secondary markets and market makers that provide liquidity for these securities. In the absence of these pre-conditions, the government faces a trade-off between maturity and currency mismatches. It may make sense to have a debt mix that includes an important component of external liabilities, despite the associated currency mismatch. In the long run, the objective of the authorities should be to deepen the domestic capital markets. Due to the lower risk levels and the greater homogeneity of the securities it issues, the central government has a vital function to perform in the development of longer-term primary and secondary markets for domestic securities, including the creation of benchmarks for private-sector debt instruments. The existence of a government bond enables the market to separate out sovereign risk from firm risk more easily, and some assert that this facilitates corporate borrowing.

### **13.0 Conclusion: Microeconomic Interventions and Other Heterodox Measures**

Bhattacharya, Amar et al (2000) observes that the claim is sometimes made that such micro-economic interventions should be avoided because they lead to distortions; however, there are several responses to this objection. First, in developing countries especially, there are limits to the effectiveness of the standard instruments; the losses from 'Harberger triangles' (losses in efficiency, from, say, tax interventions) pale in comparison with those arising from the underutilization of a country's resources.



Moreover, developing countries are rife with market inefficiencies; even in developed countries, capital markets are characterized by imperfections, many associated with inherent limitations caused by imperfect information. Those who argue against these micro-economic interventions assume the economy is well described by a perfectly competitive model with perfect information and no distortions— an assumption inappropriate for even developed countries, but particularly irrelevant for the developing world. Well-designed microeconomic interventions can increase the efficiency of the economy at the same time that they contribute to economic stability.

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