4 Post-crisis macroeconomics and least developed countries: A way forward

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4.1 Introduction

The international community's support to the twin goals of job creation and poverty reduction in least developed countries (LDCs) is a core element of the global development agenda. More specifically, these goals are reflected in the Millennium Development Goal (MDG) 1b and the Social Protection Floor (SPF) Initiative. What role can macroeconomic policies play in supporting MDG 1b and the SPF Initiative? The standard macroeconomic framework that prevailed in the pre-crisis era and continues to prevail today offers a clear prescription: focus on stability and predictability in key nominal targets pertaining to inflation, debts and deficits. Such nominal targets usually include (1) low, single-digit inflation; and (2) prudential limits on debt-to-GDP ratios supported by low fiscal deficits. The rationale is that a commitment to key nominal targets over the medium to long term boosts investor confidence, promotes growth, creates jobs and reduces poverty.[2]

This chapter argues that the prescriptions of the prevailing macroeconomic framework are necessary but not sufficient for growth to be sustained. In any case, growth alone will not be sufficient to make significant progress towards the attainment of MDG 1b, nor will it fully fortify policy-makers in making significant progress towards the SPF Initiative. The post-crisis macroeconomic framework needs to move beyond a preoccupation with nominal targets and reflect much more on how sustainable resources can be harnessed to finance public investments in health, education, water supply, sanitation and infrastructure that are crucial for attaining MDG 1b (together with the other MDGs) and the SPF Initiative as well as supporting targeted interventions such as public employment programmes. This should be complemented by a more nuanced approach to inflation targeting that makes a distinction between overall inflation and the behaviour of food prices. In addition, promoting the agenda of financial inclusion, maintaining competitive and stable real exchange rates and

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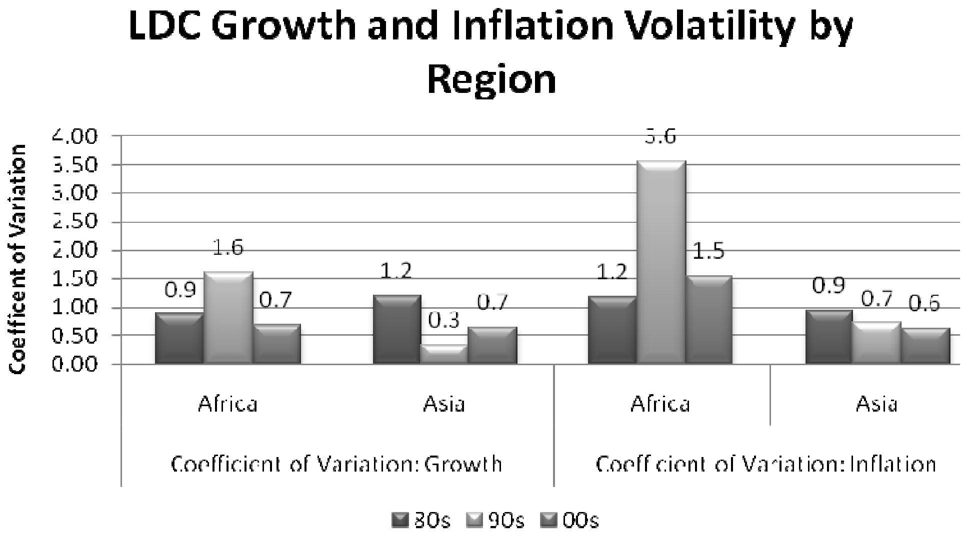
[2] The standard macroeconomic framework in developing countries was launched through the structural adjustment programmes of the 1980s and 1990s. By 1999, the era of structural adjustment lending had come to an end and had been replaced by "poverty reduction strategies" (PRS), but the focus on the standard macroeconomic framework remained intact. See IMF (2007a) for a review of the application of this framework to 29 countries in sub-Saharan Africa that received financial assistance from the International Monetary Fund (IMF).

prudent capital account management can provide much-needed policy space for LDCs to pursue a strategy of economic diversification.

4.2 The standard macroeconomic framework and its contested role in the LDC growth revival of the 2000s

Least developed countries – covering both Asia and Africa – experienced a revival of growth in the 2000s after the "lost decades" of the 1980s and much of the 1990s, as well as a downward trend in inflation in the 2000s. This revival, together with the reduction in inflation, was also associated with a significant decline in both growth and inflation volatility (measured by the coefficient of variation), as can be seen in figure 4.1, where the strongest decline in volatility occurs in African LDCs.

Figure 4.1 Least developed countries: Growth and inflation volatility, by region, 1980s–2000s



Sources: World Development Indicators, World Bank Databank (2010); volatility based on authors' calculations of coefficent of variation, aggregates compiled by authors based on available data from LDC countries.

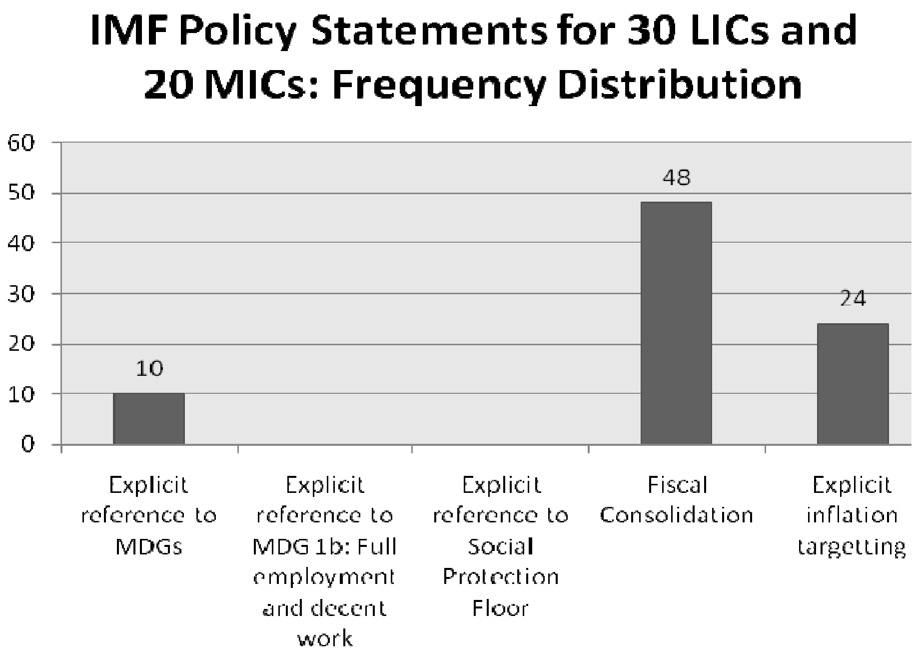
What can explain such a phenomenon? To some, the diagnosis is straightforward. As one senior IMF economist puts it: "Prudent macroeconomic policies and increased reform efforts in many countries in [Africa] laid the foundation for the growth acceleration of recent years…" (IMF, 2007b).

Others are less certain. As the UNCTAD 2010 report on least developed countries notes, the robust growth of the 2000s was propelled largely by favourable external circumstances – commodity price booms, rising exports and remittances, increased capital flows, higher official development assistance and debt relief – that are unlikely to be replicated in the more austere environment of today (UNCTAD, 2010a). One might also emphasize that the rapid growth of the 2000s was associated with a proliferation of low-productivity jobs, inadequate social security, declining wage shares and growing inequality, and insufficient structural transformation. In any case, the growth revival of the 2000s was unable to reverse the consequences of the lost decades of the 1980s and 1990s.

It appeared that, in the wake of the "Great Recession", one would move away from a "business as usual" scenario. In the case of least developed countries, the policy advice offered by the IMF during 2008–2009 was that countries with fiscal space should allow both automatic stabilizers and discretionary fiscal policy to support countercyclical measures to cope with the external demand shock engendered by the recession (Berg et al., 2009).

The emphasis on countercyclical measures proved short-lived. The IMF's latest report on the Millennium Development Goals (IMF, 2010) attaches salience to the need for "policy buffers", which essentially means low inflation and fiscal discipline. An examination of a random sample of 30 low-income and 20 middle-income countries shows that macroeconomic policy advice as manifested in the IMF's article IV consultations is dominated by concerns about fiscal consolidation, and to a lesser extent, inflation targeting. There are hardly any explicit references to the Millennium Development Goals and none to MDG 1b or to the SPF Initiative – see figure 4.2

Figure 4. 2 International Monetary Fund policy statements on 30 low-income countries and 20 middle-income countries, frequency distribution, 2010



Source: IMF article IV consultations, latest, based on authors' calculations.

4.3 Aligning macroeconomic policies with the twin goals of job creation and poverty reduction in LDCs: Some suggestions

Given the risk of a "business as usual" scenario, what are the alternatives? This section summarizes the elements of a macroeconomic framework that has the potential to lead to significant progress in job creation and poverty reduction in the least developed countries. The discussion commences with fiscal policy and proceeds to other policy areas.

4.3.1 Fiscal policy: Using the fiscal diamond to enhance fiscal space

The role of fiscal policy is twofold. First, robust and regular estimates are required to assess the financing needs associated with the Millennium Development Goals and the SPF Initiative. An illustration of such estimates is shown in box 4.1. The message is that there are conspicuous and unmet financing needs. More importantly, they are likely to get worse as the Great Recession has, at least according to one study, created a huge "fiscal hole" in the case of LDCs.

Box 4.1 Financing the Millennium Development Goals and the social protection floor

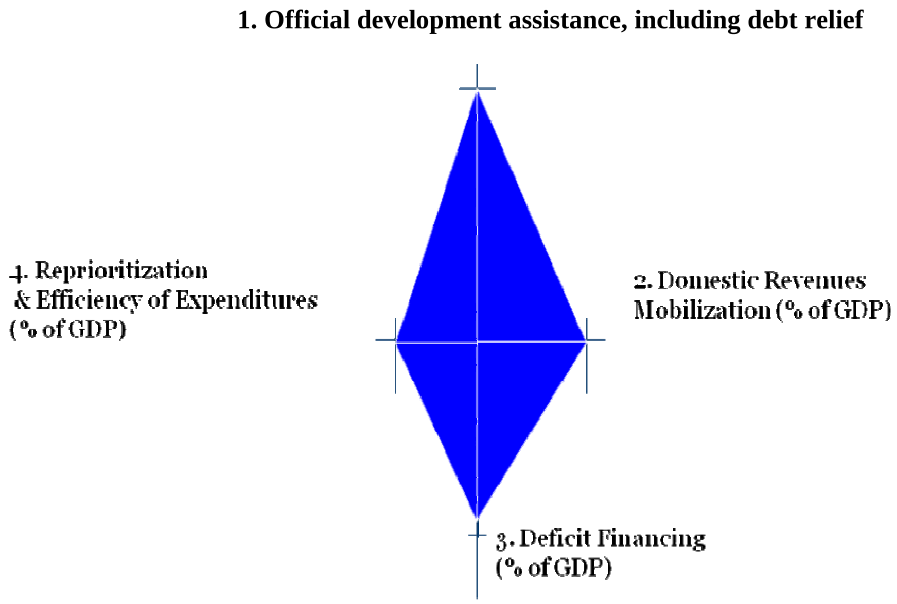
The World Bank estimates that, if countries improve their policies and institutions, the additional foreign aid required to attain the MDGs by 2015 is between US$40 and US$60 billion a year (Devarajan et al., 2002) and the Asian Development Bank (ADB) estimates the additional per person costs for the poverty income goal to be between US$550 and US$880 (Markandya et al., 2010). To meet these per capita costs, foreign aid commitments would have to be twice their current projected size.

A forerunner to the SPF is the "basic social security package" that was proposed by the ILO in 2008. Such a package includes the following elements: (a) basic old-age and disability pensions (benefits set at the rate of 30 per cent of GDP); (b) benefits at the rate of 15 per cent of GDP for the first two children below the age of 14; (c) 100 days guaranteed employment at a wage of 30 per cent of per capita GDP for a maximum of 10 per cent of all people of all ages; and (d) essential health care based on one health professional per 300 persons. Using these benchmarks, the study examined 12 countries, out of which seven are in Africa (Burkina Faso, Cameroon, Ethiopia, Guinea, Kenya, Senegal, United Republic of Tanzania) and the rest in Asia (Bangladesh, India, Nepal, Pakistan and Viet Nam), using projections for the period 2010–2030. The fiscal requirements range from over 10 per cent of GDP (Burkina Faso) to a little over 4 per cent (Guinea).

The fiscal challenges of meeting the MDGs and the SPF in the wake of the Great Recession are brought out by an OXFAM study. It shows that the Great Recession has created a huge "fiscal hole" in the 56 low-income countries (LICs), by reducing their budget revenues (and their ability to spend to confront the crisis and reach the MDGs) by $65billion over the 2009–2010 period (Kyrili and Martin, 2010). As a result of the fiscal hole and following some fiscal stimulus to combat the crisis in 2009, most LICs are cutting MDG spending, especially on education and social protection.

Second, the aim is to identify a country's "fiscal diamond" as shown in figure 4.3. The fiscal diamond is a compact, but critical, summary of the way one can increase fiscal space to meet the core development goals. This entails mobilizing domestic and external resources within a framework of fiscal sustainability to support enhanced public investment in health, education, water supply, sanitation and infrastructure –all critical in attaining the MDGs. This needs to be combined with sustained efforts to harness resources to finance an SPF that includes such targeted interventions as public employment programmes.

Figure 4.3 The “fiscal diamond” (percentage of GDP)

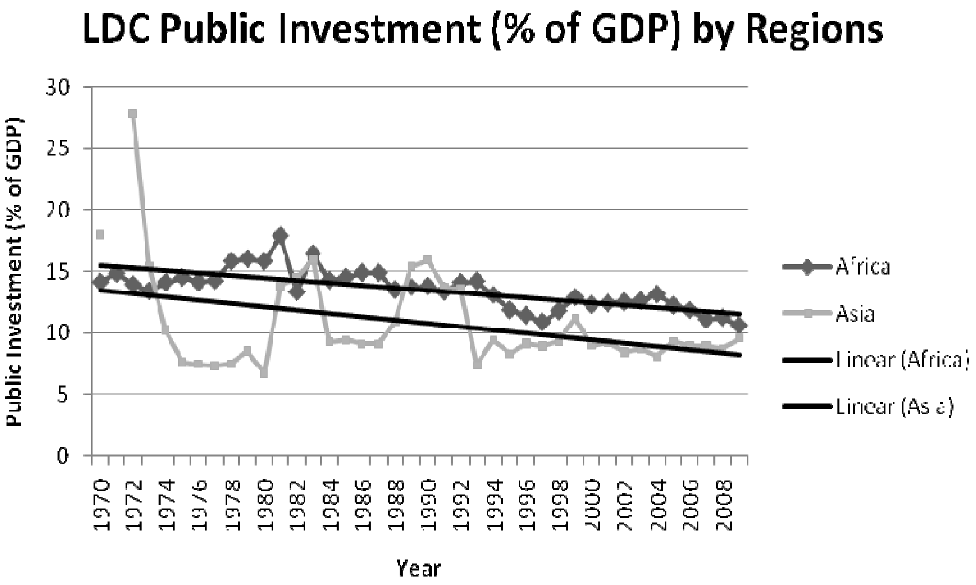


Source: Roy, 2009

It is well known that there has been a secular decline in public investment in the LDCs, as shown in figure 4.4. What is now the scale of the public investment challenge facing LDCs? The Commission on Growth and Development (2008) suggests that a public investment rate of around 7 per cent of GDP in infrastructure is needed as an important element of a national development strategy. Yet the data suggests that barely 2 to 3 per cent of GDP is invested in infrastructure in many developing countries and emerging economies. This is clearly a policy challenge, given that 50 per cent of enterprises in Asia and Africa cite lack of access to electricity as a major constraint on their business operations.[3]

[3] These estimates can be derived from online data available at www.enterprisesurveys.org.

Figure 4.4 Public investment in LDCs, Africa and Asia, 1970–2008 (percentage of GDP)



Sources: World Development Indicators, World Bank Databank (2010)

Addressing these concerns requires determined public action to cope with the public investment deficit that has built up over decades. Hence, a resource mobilization strategy pursued through improved budgetary execution and enhanced domestic revenue-to-GDP ratios in countries with a low tax burden are core planks of a development strategy.[4] For example, estimates show that the Bangladesh Government can fully upgrade its public employment programme to an Indian standard national employment guarantee scheme by increasing its historically low tax-to-GDP ratio by 3 percentage points and by better utilization of its existing resources (Islam et al., 2011). This can be complemented by other initiatives, such as public–private partnerships and efforts to tap domestic savings and channel them into productive investment. In addition, where energy taxation can be used effectively and equitably, it can become a new source of revenue that has the benefit of supporting initiatives to cope with climate change.

Domestic resource mobilization needs to be supported by enhanced development assistance from donors. Hence, maintaining aid commitments and exploring feasible options for identifying alternative sources of reliable and low-cost development finance to supplement traditional sources are important elements of a development-friendly macroeconomic framework.

As part of enhanced development assistance, an important issue is the role that debt relief has played in enhancing fiscal space for LDCs, as shown in box 4.2. While debt relief in aggregate has contributed to enhancing fiscal space, country-specific experiences suggest that there is significant scope for improvement.

[4] This is an issue on which there is broad agreement in the international community (IMF, 2010; UNDP, 2010).

Box 4.2 The relationship between debt relief and fiscal space in LDCs

According to the IMF's African Department Director, the fiscal space created by high levels of debt relief is supporting poverty-reducing spending in LDCs (IMF, 2007b). Initiatives such as the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief Initiative (MDRI) have substantially reduced the debt-to-GDP and debt-to-export ratios of a significant subset of countries in the LDC group, improving the overall sustainability of their debt and freeing considerable amounts of resources that were previously earmarked for debt servicing (UNCTAD, 2010a).

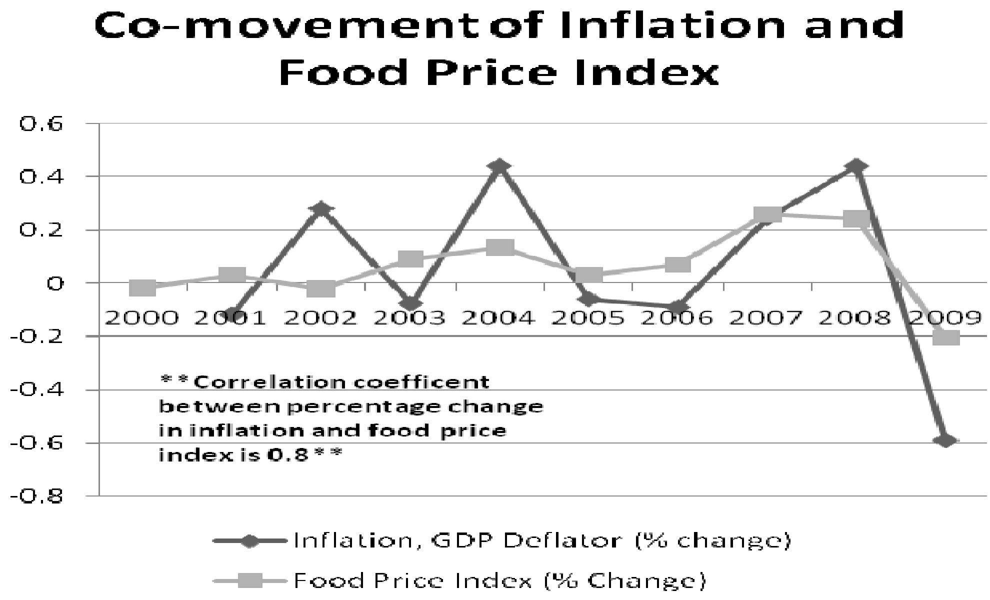
The trends indicate that the level of debt relief for LDCs spiked at a high level from 2005 to 2006, following the Gleneagles Summit, but swiftly came down in 2007. Total debt service steadily declined from above 20 per cent of total exports to less than 5 per cent in 2008. However, this progress does not mean that the debt issue is no longer relevant in LDCs. As of April 2010, 14 LDCs which still remained in debt distress or at high risk of debt distress were not identified as HIPCs or had not reached the completion point. Even in the best-case scenario of a fast recovery and a long-term growth path, LDCs and developing countries alike will face higher debt burdens as a result of the global economic crisis.

The relationship between debt relief and fiscal space differs across LDCs. The fiscal space assessments for Malawi and Mozambique noted that debt relief under the HIPC Initiative had expanded fiscal space and thereby allowed for a scaling up of public investments (UNDP, 2010). The MDG Report for Malawi noted that with 84 per cent of the country's external debt stock cancelled, the country's annual debt service had been reduced to US$15 million, freeing up US$110 million for expenditures in priority programmes. However, one country study, using the MDG framework to critically examine fiscal policies in Zambia, finds that the Zambian Government enjoys very little "policy space' "and when all calculations are carried out and attendant conditionalities on policy-making are taken into account, HIPC debt relief actually provides marginally less fiscal space, rather than more (Weeks and McKinley, 2006).

4.3.2 Monetary policy: Going beyond inflation targeting

In coping with inflation in LDCs, recent economic history suggests that it is necessary to make a distinction between the overall inflation rate and the behaviour of food prices, given that there is a close correlation between the latter and the former (figure 4.5). In particular, food prices – which have risen again – have threatened to derail progress in the attainment of the MDGs, exposed the paucity of social protection systems and have engendered social unrest. The latest estimates are that the current increase in food prices has pushed over 40 million people in the developing world into a transient episode of poverty (World Bank, 2011). The appropriate response in this case is to undertake policy actions across a wide front to improve food security. Using restrictive monetary policy to tame rising food prices is unlikely to work.

Figure 4.5 LDC Inflation and the Food Price Index, 2000–2009 (percentage changes)

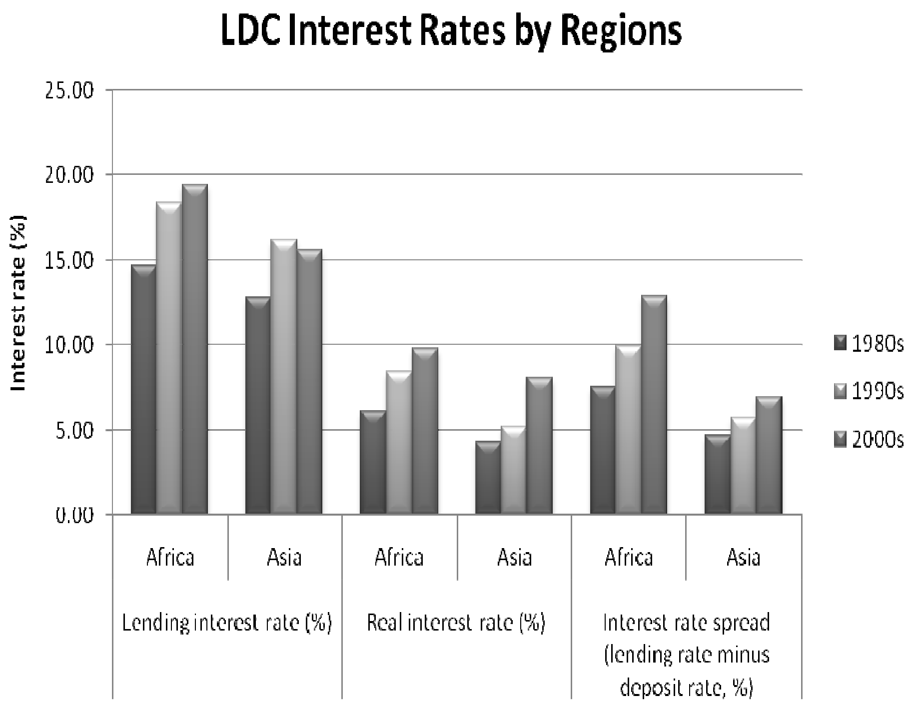


Sources: World Development Indicators, World Bank Databank (2010); US Energy Information Association; FAO; aggregates and calculations compiled by authors.

When judged from a cost-of-borrowing perspective, it is by no means clear that the low inflation environment of the 2000s has provided tangible benefits to the private sector. The median real lending rate in LDCs has risen between the 1990s and 2000s (figure 4.6) Furthermore, LDCs are afflicted by rising interest rate spreads. Hence, a major challenge for monetary policy in LDCs is to find ways of reducing the cost of borrowing. This means taking account of the extent to which lack of access to finance acts as a binding constraint on growth. Private-sector firms in developing countries usually regard lack of access to finance as a major impediment to business operations and their employment-creating potential.[5] Hence, central banks and financial authorities have an obligation to enhance financial inclusion without forsaking their prudential obligations and their role in safeguarding price stability. Enhancing financial inclusion means (1) increasing access to finance for the private sector, especially small and medium-sized firms; (2) encouraging the development of well-regulated and efficient microfinance institutions (MFIs) that can respond to the financing needs of poor and vulnerable households that seek durable self-employment.

[5] These estimates can be derived from online data available at www.enterprisesurveys.org.

Figure 4.6 Least developed countries: Interest rates, by region, 1980s–2000s (percentages)



Source: World Development Indicators, World Bank Databank (2010); aggregates compiled by authors.

4.3.3 Exchange rate and capital account management: Aiming for competitive and stable real exchange rates and coping with capital flows

In the sphere of exchange rate regimes and capital account management, the aim should be the adoption of institutional arrangements that sustain competitive and stable real exchange rates, given the evidence that the real exchange rate exerts a powerful influence on structural transformation. (Rodrik, 2008). More specifically, a study on Sub Saharan Africa using data for the period 1970–2004 shows that real exchange rate overvaluation reduces growth and impedes export diversification (Elbadawi et al., 2008). As box 4.3 shows in the case of Malawi, moving towards a competitive and stable real exchange rate regime is an essential component of a pro-employment macroeconomic framework.

In cases where unrestrained capital flows pose a policy challenge, a more prudent approach to capital account management might be justified, as this opens up policy space for initiatives that create employment. (Ostry et al., 2010). Forty per cent of African LDCs have significant restrictions on the capital account (Berg et al., 2009) but for the remaining 60 per cent there is little or no evidence that capital account liberalization has necessarily provided them with the capacity to boost growth (Cerra et al., 2009).

Box 4.3 Malawi: The exchange rate regime and its implications for growth and employment

A study commissioned by the ILO shows that "macroeconomic policy, particularly exchange rate policy, matters a great deal" in affecting economic growth and employment creation. The study maintains that Malawi has a "tradition of attempting to maintain a stable nominal exchange rate, i.e., fixing the value of the Kwacha in terms of US dollars…The official purpose of maintaining a stable exchange rate is primarily to reduce inflation," with the Government arguing that this anti-inflation dimension of exchange rate policy is worth preserving because export supply is not very responsive to the exchange rate. This might be true in the short term, but ignores the role that a competitive real exchange rate plays in supporting structural transformation in the medium term. The study shows that, given the higher inflation rate in Malawi relative to its trading partners, attempting to maintain a nominal exchange rate leads to a real appreciation and also induces volatility. There is also evidence that the real appreciation is associated with a sharp jump in import penetration from 44 per cent of GDP in 2007 to 53 per cent in 2008. The study urges policy-makers to recognize that with a competitive and predictable real exchange rate regime, "firms would most likely have created more jobs, invested more and diversified more in Malawi".

Source: ILO; Government of Malawi (2010) , pp.84–87.

4.4 Conclusion

In order to achieve progress towards the twin goals of MDG 1b and the SPF Initiative, the post-crisis macroeconomic framework needs to move beyond a preoccupation with inflation targeting and fiscal discipline. Domestic and external resources have to be mobilized to support enhanced public investment in health, education, water supply, sanitation and infrastructure that are central to the goal of achieving the MDGs and SPF Initiative. Monetary policy needs to move beyond inflation targeting, as recent data highlight the need to make a distinction between the overall inflation rate and the behaviour of food prices**.** Moreover, it is clear that LDCs are afflicted by rising interest rate spreads, signalling the need to reduce the cost of borrowing by taking into account the extent to which lack of access to finance acts as a binding constraint on growth. Central banks and financial authorities should work towards enhancing financial inclusion without neglecting their role in safeguarding price stability. Moreover, it is essential to move towards a competitive and stable real exchange rate regime, as such a regime is an essential component of a pro-employment macroeconomic framework. Finally, where unrestrained capital flows pose a policy challenge, a more prudent approach to capital account management might be justified, as this would open up policy space for initiatives that create employment

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