

The Macroeconomic Framework of Poverty Reduction An Assessment of the IMF/World Bank Strategy

- A Critical Review of the PRSP Sourcebook Chapter 6
from September 21, 2000¹ -

Hansjörg Herr and Jan Priewe*

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Badensche Str. 50-51, D-10825 Berlin

Editors of the Working Paper Series:
Gert Bruche, gbruche@fhw-berlin.de
Hansjörg Herr, hansherr@fhw-berlin.de, Tel.: +49-30-85789-124
Franz Herbert Rieger, rieger@fhw-berlin.de

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* Members of the Academic Board of „Macroeconomic Policy Studies“

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Summary

1. This paper analyses the macroeconomics of poverty reduction, providing a critique of the macroeconomic chapter 6 of the World Bank Sourcebook on poverty reduction strategies (PRSP Sourcebook). In addition to this criticism we outline alternative macroeconomic guidelines concerning monetary, exchange-rate and fiscal policies for development strategies targeted at poverty reduction

2. First, we agree broadly with the notion of a strong link between economic *growth and poverty reduction*. Sustained per capita economic growth normally does reduce poverty unless the economy is characterised by absolute dualism and completely divided. There are several channels by which growth and poverty reduction are linked: one is direct pro-poor growth, another is growth-induced additional demand for the products and services produced by the poor, and an important third channel is that poverty reduction measures require public finance for schooling, health services, sanitation etc. which is to some extent growth dependent. However, there are strong country-specific differences between poverty rates of countries with similar per capita income and growth rates. So (re)distribution matters a lot. Pro-poor fiscal policy can help redistribute income and wealth and create less inequality. Under conditions of low or negative per capita growth poverty reduction is extremely difficult. The traditional Kuznets-curve approach of temporarily increasing inequality during a long phase of development is rejected. The key question is not the growth-poverty relationship itself, but how to generate and distribute growth in a pro-poor manner.

3. Poverty reduction strategies based on growth as a necessary but not sufficient condition require certain macroeconomic policies. The authors of the sourcebook call for a *stable macroeconomic framework* constituted mainly by the absence of severe macroeconomic imbalances caused by exogenous shocks and incorrect policies. The implicit assumption is that a market economy (be it developed or undeveloped) is endogenously stable if not troubled by exogenous disturbances; further, since developing economies are small, open and dependent, they are prone to exogenous shocks, and flexible prices are regarded as the appropriate shock absorber.

The sourcebook has an unclear and very limited understanding of macroeconomic (in)stability. Inflation that is below two digits, budget deficits that are not too high and a balance of payments deficit that is not too large are seen as sufficient. This set of conditions is thought to be all that macro policies can contribute to achieving growth, the rest is to be achieved through „structural measures“ which are mainly conceived as improvements in allocation and competition and the reform of property rights through privatisation. The term „structural measures“ also includes „good governance“ which is regarded as a portmanteau term for institutional changes. In this respect we do agree: workable institutions of various kind are urgently needed in order to facilitate investments, to create appropriate incentives and disincentives for economic behaviour and to ensure the implementation of basic rules. We primarily see a lack of workable basic financial institutions and the respective rules.

Besides necessary institutional changes we call for a much broader role for active macro policies in promoting development and poverty reduction. Macroeconomic stability also implies a balance of aggregate supply and demand on the goods as well as on the labour market, and in the case of the labour market, stability requires real wages above the poverty line. Thus we call for growth enhancing macroeconomic policies which include a pro-poor employment policy. The mere absence of inflation and extreme budget deficits does not induce growth – the crucial question is how to get from stabilisation to growth. At the centre of this question stands the issue of increasing aggregate investment. The sourcebook's answer – structural measures – we reject.

4. There is no clear *relationship between allocational improvements and growth* although this is one of the cornerstones of neoclassical thinking. Certainly, improving allocation in principal is efficiency enhancing and desirable. Distorted prices, low competition, regulations that act as disincentives, weak institutions, corruption or inefficient property rights – all this should, no doubt, be changed. However, simple liberalisation of all markets does not necessarily lead to better allocation; searching for efficient allocation and institutions is a long and difficult process. But even perfect allocation, whatever that may be, will not trigger off growth in the sense of moving onto a sustained higher growth path. An increase in GDP would only occur if all factors of production were at the outset fully employed; but this would be a single once-and-for-all effect which does not lead to sustained higher growth. On the other hand, structural improvements in many cases do lead to lower employment, higher micro efficiency and lower GDP; whether such negative short-run effects are followed by a later upturn in the form of a J-curve is quite uncertain. It mainly depends on the determinants of investment. Economic history provides plenty of evidence that even under conditions of unfavourable allocation, growth, even high growth can occur for lengthy periods.

5. Conditions for growth depend to a large extent on macroeconomic policies, especially monetary and currency conditions, as well as on demand expectations which can be influenced to a certain degree by policies. The establishment of *stable domestic financial markets* in domestic currency (credit markets of the various kinds, stock and bond markets) is one the core problems for capital accumulation and for development in general. Macroeconomic policies have to be geared towards this aim, appropriate financial institutions must be set up. The functioning of stable financial markets requires *inter alia* relative price stability, exchange rate stability, a balanced current account (or movements in this direction) and to a certain extent capital controls. For the design of economic policies it makes a big difference whether the optimal allocation of scarce resources is the first aim of economic policies or the creation of stable financial markets aiming at capital formation and production increases.

6. In order to induce growth, *active* macroeconomic policy might increase fiscal deficits, lower interest rates or increase exports relative to imports. The sourcebook does not discuss this issue because it does not call for active macroeconomic policies. In the majority of small and open economies of developing countries active fiscal policies are not advisable, whereas the autonomy of monetary policy is (unfortunately) strongly reduced due to dependence on external constraints. Therefore, in these countries it is the case for *export-led growth policy*.

Trade balance deficit should be diminished step by step or surplus be increased. The *change* in the trade balance is relevant for the growth rate. Since current account deficits should be avoided because of financial stability arguments, trade surplus strategy would be most favourable although hard to achieve. This should lead to an increase in foreign reserves which strengthens the domestic currency.

7. Heading for optimal allocation based on *flexible prices* means looking at all prices in the same way. However, there are some prices with macro impact where too high flexibility (which implies volatility) is detrimental for growth: wages, interest rates, exchange rates. These „macroeconomic prices“ should rather be stable (or changed according to fixed rules) – a precondition for macro stability. Flexible nominal wages (real wages are not negotiated at labour markets) cannot create equilibrium in the labour market – as the price of fish does in the fish market –, but they can destabilise the price level as unit-labour costs are an important factor to determine the domestic price level. Normally, flexible exchange rate adjustments do not compensate for the differential between domestic and foreign inflation rate thus keeping the real exchange rate stable – as the purchasing-power-parity theory assumes.

8. There is no doubt that *low inflation* is necessary (although not sufficient) for sustained growth. In developing countries the main sources of high inflation are currency devaluations, central bank financed budget deficits and wage increases greater than productivity growth. Whereas the sourcebook accepts different nominal anchors for monetary policy, among them money aggregates, we resolutely plead for nominal exchange rate anchors, that is fixed exchange rates pegged to dominant hard currencies. Central banks are not apt to control money aggregates. Flexible exchange rates, especially under conditions of free financial markets, are prone to volatility and are a key source of market-induced macro instability. They are not suited to be shock absorbers. Fixing exchange rates and defending them successfully implies that domestic inflation for tradable goods is not higher than international inflation. Depending on the inflation rate in the anchor country this does not require an inflation rate of zero. Nominal wage anchors tying wages to productivity are necessary complements for a stable exchange rate. Accelerated inflation normally can only be stopped by severe austerity policies which reduce growth and thus directly or indirectly exacerbate poverty, and which often lead to devaluation and financial crises. Therefore, we call for paying more attention to price stability discipline and its far reaching implications. To be more blunt: In small open economies there will be no sufficient price stability without stable, that means fixed, nominal exchange rates for longer periods.

Low domestic inflation based on a nominal wage anchor and a fixed nominal exchange rate describe a constellation that is likely to support stable domestic financial markets and reduce the extent of a parallel-currency system. Undoubtedly for many developing countries such a constellation is not easy to realise. But the more a country can go in the direction of price-level stability and stable exchange-rates the more likely it is that the domestic financial market will unfold and reinforce domestic production and investment, reduce risks and uncertainties and lower interest rates. Of course, institutional financial sector reforms are of eminent importance.

9. The sourcebook does not call for *policies to avoid current account deficits*. The implicit idea is that in developing countries domestic saving is too low so that foreign savings inflows should be channelled into the poor economies, thereby causing capital account surpluses and current account deficits for longer periods. This is expected to reinforce capital formation. We reject this notion, firstly, because this strategy is not sustainable; secondly, because it weakens the domestic currency, which will tend to become devalued; and thirdly, because in many countries it has led to severe financial crises as real foreign debt increases thereby regularly causing bankruptcies. First and foremost, in most developing countries there is in general *no* scarcity of domestic savings – domestic investments can be financed by domestic savings if appropriate monetary institutions and rules are established. Savings follow investment, which increases employment and income. Development has to trigger-off a credit-investment-production-income sequence. Such a mechanism can start without prior saving. Only in extremely poor countries where consumption is necessarily equal or higher than aggregate income, and the latter cannot be increased, there exists an absolute capital shortage.

The main purpose for preventing current account deficits is to stabilise the domestic financial markets as foreign debt is extremely dangerous for developing countries. Current account deficits – if not financed by grants or foreign direct investment – increase debt denominated in foreign currency. In this case any devaluation will increase the domestic real-debt burden and, therefore, induce liquidity and solvency problems of banks, enterprises or the state. If this happens the coherence of the domestic financial markets and the reputation of the domestic currency will be destroyed. The absence of current account deficits is like a macroeconomic safety-net for developing countries to reduce the danger to slide in a financial crisis, which tends to depress growth for a long time. The more indebted countries are, the higher the risk of a financial crisis in the case of devaluation. Especially highly indebted countries should take care of their current account.

Low domestic inflation rate, stable or even fixed exchange rates and the absence of current account deficits provide a favourable macroeconomic environment for development: the domestic financial markets are stabilised by low inflation and stable exchange rate, the absence of current account deficits (or even surpluses) create expectations of future stable exchange rates, demand is created in the case of reduced deficit or increased surplus. As already mentioned above it will not be possible for all developing countries to jump into the described constellation. Nevertheless, this constellation should be the medium- or long-term target even for countries with huge current account deficits, high inflation and unstable exchange rates.

10. In order to keep the current account in balance or, even better, to achieve a current account surplus by means of an export-led development strategy, under certain conditions capital import controls are necessary; they are much more important than capital export controls which are almost impossible to implement for longer periods. These proposals do not mean that there should be no capital imports at all; the salient point is the *balance* of capital flows.

We recommend that foreign direct investment (FDI) should be the main form of capital import, (except grants for imported products that cannot be produced in the country). FDI can (under certain conditions) have a positive impact on development. In this case the exchange-rate risk is on the side of the investor – in the case of credits it is on the side of the domestic debtor. Capital markets should only be opened and liberalised in the long run as development proceeds. As is the case for all countries, it is impossible to simultaneously achieve stable exchange rates, monetary autonomy, *and* free financial markets („the impossible trinity“). For developing countries there should be no doubt that the last of these is the least important.

11. As far as fiscal policy is concerned, poverty reduction requires more public finance earmarked for pro-poor-infrastructure and services. In most cases, it is probably not feasible to regroup public spending to the extent necessary; therefore, increases in taxes or fees will then be necessary, except in the case of public investments that can be financed by domestic public loans (as long as the sustainability of the public debt is guaranteed). The crucial issue is whether scarce public finance can be supplanted by foreign aid in the form of concessional loans or grants. Here narrow constraints for using foreign funds are outlined, for instance: if foreign aid is used for imports of goods, this might crowd-out domestic production and thus lower domestic demand, production and saving; using foreign finance for buying domestic goods and services can lead to inflation in the same way as central bank financed public debt; foreign finance can lead to current account deficits tending towards devaluation. The central point is that, for the majority of poverty reduction measures and the majority of countries concerned, neither imported goods nor imported capital is needed. Foreign funds are only necessary in the following cases: if additional import goods are unavoidably necessary and not producible for technical reasons and at the same time it is not possible to earn the necessary hard currency by increasing exports or reducing other imports; in emergency cases when domestic production of the pro-poor goods needed is not possible (e.g. exogenous shocks, floods, draughts, earthquakes, during and after wars etc.); and for the relief of foreign debt to lower the burden of foreign exchange outflows. In general, grants are preferable to loans, since the real value of loans increases in the case of devaluation.

12. Almost 80% of the world-wide poor live in relatively *large* low- and middle-income countries (with more than 60 million inhabitants) which must and can take care of poverty reduction by themselves and with domestic finance. Those very poor countries with a very high influx of official development aid with respect to GDP (as an arbitrary threshold we use 10%) account for less than 10% of world poverty. It is not the threshold that counts but the tendency: gradually increasing deficits and financial inflows. These countries are characterised by extreme current account deficits. There is no doubt that these very poor countries which are heavily indebted and receive high amounts of development aid relative to GDP are at the time being not capable to realise a self-reliant development constellation in the short and medium term. All the advice for more macroeconomic stability is in vain if these impoverished countries cannot do without 10 to 30% foreign aid relative to GDP or even more in the future.

They are trapped in a dilemma: they need foreign funds for a long period in order to survive, but these funds trap them in dependency and severe macroeconomic imbalance. For these extremely dependent transfer economies more foreign finance might at best be of immediate humanitarian help but will increase dependency.

Some of these countries fell into the debt-and-transfer-trap due to wars or natural catastrophes, others due to gradually increased current account deficits.

The sourcebook, especially chapter 6, is not clear whether it is mainly addressing this country group which is not capable of surviving independently in the short and medium run, but which accounts only for a minor part of world-wide absolute poverty, or whether it is targeted at the other low- and medium income countries which account for the majority of world poverty. Even in terms of the sourcebook, countries with stark balance-of-payment disequilibrium are far away from what chapter 6 defines as macroeconomic stability. We propose to distinguish clearly between these two country groups because different poverty reduction strategies have to be employed in each. For the very poor transfer-countries it will not be possible in the short and medium term to jump into the positive development scenario of a balanced current account, low inflation and stable exchange rate. Country-specific strategies have to be designed how and when to reduce the extreme macroeconomic imbalances step-by-step. For the more developed and less dependant countries the positive development constellation can be reached within a short time period. In this paper we do not comment whether the heavily indebted poor countries will be permanently trapped or whether alternative options are feasible. More research is urgent.

13. The development constellation we recommend – to be achieved step-by-step by the least developed countries and faster or even immediately by the country group with more favourable conditions – has the following elements:

- promote exports (abolish export restrictions) to stimulate demand, especially by fully opening markets in the developed countries for such products from developing countries,
- promote step by step a balanced current account or even a surplus in the current account to prevent the built-up of foreign debt and attract more export demand,
- concentrate on FDI as capital import, restrict all risky forms of capital inflow as portfolio investment and short-term bank credits,
- employ capital controls, especially on capital imports,
- lower indebtedness by debt relief,
- stabilise the nominal exchange rate and keep inflation under control to induce wealth owners to hold their assets in domestic currency,
- stimulate domestic investment,
- reorganise the domestic financial sector to offer loans at low but positive real interest rates,
- redistribute GDP by appropriate fiscal policy measures towards the poor who are normally not (or very little) engaged in foreign trade. In addition grants can be used to import urgently needed goods that cannot be produced in the country.

0 Introduction

The World Development Report 2000/2001 “Attacking Poverty” moves poverty reduction into the centre stage of development policies applied by the World Bank and the International Monetary Fund as well (World Bank 2000a). Ten years ago the World Development Report dealt with the same topic, but the 1990s were not a success in attacking poverty, which still affects about one quarter of the population of the “Third World”. Traditionally poverty reduction was regarded as an automatic consequence of economic growth triggered off by macroeconomic stability and pro-market allocational improvements. As this did not work out as expected, the Washington institutions embarked at the end of the 80s on “Social Dimensions of Adjustment” (SDA) which were supposed to complement traditional “Structural Adjustment Programmes” (SAP) during a severe short-term adjustment period. The 1990 Report called for labour-intensive growth, an extension of social pro-poor services and the construction of social safety nets. However, SAPs were kept more or less unchanged, and after the Asian crisis the Washington institutions, and in particular the IMF, came under heavy attack. One of the salient points was that SAPs, based on a certain neoclassical/monetarist perception of economic development, in many cases did not support or precipitate growth in the way that it claimed. The macroeconomic rationale of this policy approach seemed (and still seems) to be rather fundamentally flawed.

The recent second attempt at attacking poverty resembles the first one, but there are some new concepts. Now poverty reduction is to become the touchstone for the success of development strategies, something which we consider a big step forward. Economic and anti-poverty strategies are to be fully integrated, distribution and the composition of growth are to be addressed, macro policies are to be re-examined for their impact on the poor; fiscal policy is to be focussed on poverty reduction, as well as monetary and exchange rate policies; the scope for foreign funds to relieve poverty is to be enhanced, the donors’ community should become better co-ordinated; finally, debt relief for highly indebted countries is to be connected with pro-poor measures.

The initiative for highly indebted poor countries (HIPC) calls for elaborating “Poverty Reduction Strategy Papers” (PRSP), and the IMF announced a new framework for concessional loans in the form of the “Poverty Reduction and Growth Facility” (PRGF). The crucial issue for us is to identify what has really changed, in what direction change is going, and what is just a new type of wording and labelling for old wine in new bottles.

The World Bank’s “PRSP Sourcebook” offers one chapter on macroeconomic issues (chapter 6) (World Bank 2000). This chapter addresses poverty reduction in developing countries *in general*, not differentiating between extremely poor, heavily indebted and highly dependent countries (like the majority of the sub-Sahara-African countries) and other low income countries with high absolute numbers of poor (e.g. like India). The main propositions of this chapter can be summarised as follows:

- Economic growth is the most important policy against poverty, although it alone is not sufficient; it must be complemented by redistribution. The traditional Kuznet-trade-off between growth and equity is rejected.
- Growth requires macroeconomic stability which is somewhat vaguely defined as the absence of severe macroeconomic imbalances, mainly characterised by single-digit inflation rates. Inflation impacts the poor. Furthermore, growth is to be enhanced by “structural measures”, such as privatisation, trade liberalisation, removing price distortions etc. as well as basic institutional reforms and better governance. Private capital accumulation is seen as the engine of growth.
- Macro policies should mainly guarantee price stability by appropriate restrictive monetary, exchange rate and fiscal policies. Flexible exchange rate regimes seem to be preferred, as well as liberalised financial markets. A current account with a modest deficit is regarded unproblematically as indicating net capital imports which might augment domestic capital formation.
- Costly social security nets are rejected, although the authors admit that poverty reduction requires better schooling, sanitation, health services etc. Pro-poor fiscal measures are to be financed by fiscal redistribution, and to some extent by foreign funds. The latter should not jeopardise macro stability but the constraints are not outlined. The taxation system should be changed, strict budget deficit thresholds are rejected.
- Many propositions remain rather vague and murky leaving discretion for traditional structural adjustment measures as well as different policies without clear contours.

This paper is a critical comment on „chapter 6“ of the sourcebook. In „chapter 6“ many of the traditional IMF/World Bank philosophies are contained, and some new ideas are added. We understand the „poverty mainstreaming“ approach as a good chance to re-examine some of the basic macroeconomics and the respective macroeconomic policy consequences which the IMF/World Bank traditionally apply. „Chapter 6“ argues that growth matters for poverty; here we agree to a large extent, but call for additional consideration of specific pro-poor-growth and redistributive activities (section 1).

Much of „chapter 6“ deals with what „macroeconomic stability“ means, how it can be achieved and what is necessary for macroeconomic stability to trigger off growth. Here we criticise the fact that „chapter 6“ uses a far too narrow and rather unclear understanding of „macroeconomic instability“ (section 2.1). One of the fundamental underpinnings of „chapter 6“ is the neoclassical notion that saving creates investment, and that domestic savings in less developed countries (LDCs) need to be reinforced by foreign saving in various forms (credits, grants, FDI etc.). Here we disagree and outline the fundamental relationships from a Keynesian perspective. One of our key points is the proposition that the current account should be more or less balanced or even better in surplus, irrespective of foreign grants (section 2.2 and 2.3).

The basic proposition of the „chapter 6“ authors stipulates that the absence of external shocks and strong macro imbalances in combination with so-called „structural measures“ will induce investment and growth. „Structural measures“ are, on the one hand, more or less the content of traditional „Structural Adjustment Programmes“ of the IMF, focussing on a better allocation of resources, more competition and property rights reforms.

We contend that there is no linkage between allocation and growth, neither in theory nor in practice (section 2.4). Therefore, active growth stimulating measures are required. On the other hand, structural policies can be understood as institutional reforms and improved governance; indeed this is extremely important as a basic precondition for development although it should not be mixed up with allocational improvements.

When it comes to the appropriate monetary and exchange rate policies in LDCs, „chapter 6“ is not clear enough. The authors praise nominal anchors but argue that a growth target for monetary aggregates together with flexible exchange rates can be used as an anchor as well as the nominal exchange rate. Here we call for a strong nominal exchange rate anchor and a complementary monetary policy (section 3). This anchor has to be underpinned by a nominal wage anchor and incomes policy. Balance of payment distortions are of paramount importance for macro instability, inflation, indebtedness, fiscal budget deficits etc.

We do agree with much of what is said about fiscal policy (see section 4). But “chapter 6” is not clear on the criteria for using foreign funds in poverty reduction programmes. We argue that foreign capital or grants can only support poverty reduction in very specific cases; if applied improperly, it can generate severe unintended macroeconomic imbalances. This section draws heavily on theoretical arguments developed in section 2.

In general, we feel that aiming at concrete policy conclusions in this field is, unfortunately, hardly possible without some detours into the area of fundamental economic theory. However, the implicit policy consequences are obvious. We return from the detours to the salient points of agreement and dissent, as set out in our conclusions in section 5.

1. Growth and Poverty – Linkages

“Chapter 6” starts with the assertion:

“So why is there a chapter in the Sourcebook for Poverty Reduction Strategies on macroeconomic issues? Because economic growth is the single most important factor influencing poverty, and macroeconomic stability is essential for high and sustainable rates of growth. Hence macroeconomic stability should be a key component of any poverty reduction strategy.” (World Bank 2000, p.2)

In principal, we agree with the first part of the statement whereas the second depends on the definition of "macroeconomic stability" (see section 2.1). In this section we first analyse the growth-poverty relationship in more detail in order to explore the scope for redistribution, then we review briefly the direct relationships between macroeconomic imbalances and poverty.

We are sceptical about stating a universal “law” proposes a stable quantitative relationship between growth and poverty². Furthermore, we do not believe that there is a uniform pattern of income distribution and growth in the economic history of all nations, as stipulated by the Kuznet-curve. There are differences between countries, as well as between historic time sequences within a country. One extreme is the income development in the US during the last decades: real wages for the bottom quintile of the labour force declined by 9 per cent between 1973 and 1997, but average per capita real income grew by 70 per cent (Weisbrot et al. 2000, p. 8 f.). Growth was *not* good for the “poor” if we regard the bottom quintile as poor. On the other hand, in the majority of countries the distribution of income is rather stable over longer periods; of course this implies that the lower income brackets participate in growth. If this is true, the US experience seems to be rather exceptional. In order to outline a poverty reduction program for a LDC it is essential to analyse a country’s specific historical record – regression analyses of hundreds of countries are not helpful if the specific country deviates from the average performance. A cross-country overview shows that countries with similar per capita income encounter extreme differences in poverty (see World Bank 2000a, p. 282 ff.).

First of all, we need a definition of poverty applicable to LDCs. The proposal of “chapter 6”, like that adopted in the *World Development Report 2000*, seems acceptable: physiological and social deprivation, the former being closely related to basic material needs and low monetary income and consumption levels. Persons living in a pure subsistence non-monetary economy trying to satisfy their basic needs by their own or their family’s labour will be called poor. An income of below 1 US \$ a day is considered to constitute absolute poverty. Access to health services, sanitation, water, primary school-enrolment are included in the definition. Such services are either public goods paid by taxes or fees or via markets out of individual income.

If Y is aggregate income (let us say net GNP), net income is distributed *directly* to the poor and the non-poor (Y_{dp} and Y_{dnp}), and *indirectly* as government transfers (in cash and in kind) to the poor and non-poor (G_N and G_{NP}). The rest of aggregate income is directly consumed and/or invested by government expenditure and not attributable to the different income groups:

$$(1.1) \quad Y = Y_{dp} + Y_{dnp} + G_p + G_{NP} + G$$

So the overall income of the poor is: $Y_p = Y_{dp} + G_p$

and the poor’s share of total income is (β): $\beta = (Y_{dp} + G_p)/Y$

If PO is the number of the *income poor*, then Y_{dp}/PO is the average income of the income poor. Let us assume that the poor get government transfers and can use public services. If the poor get G_p from the government – if a poor person gets more than is necessary to take him out of the group of the poor this is not part of G_p - then G_p/PO is the average transfer income for the poor.

² See Dollar and Kraay (2000) and the critique by Weisbrot *et al.* (2000)

Poverty to the extent of PO exists if both of the following conditions are fulfilled:

$$(1.2) \quad Y_{dp}/PO < \text{US } \$ 365 \quad \text{and} \quad G_p/PO < g_m$$

US \$ 365 is the minimum direct monetary income per annum considered necessary, and g_m is the minimum per capita amount of public services that is necessary to satisfy basic needs. Although g_m is a cash figure, here it should represent services in kind. If people are poor, the aggregate income gap ΔY_p that is required to lift the poor from under the poverty line is

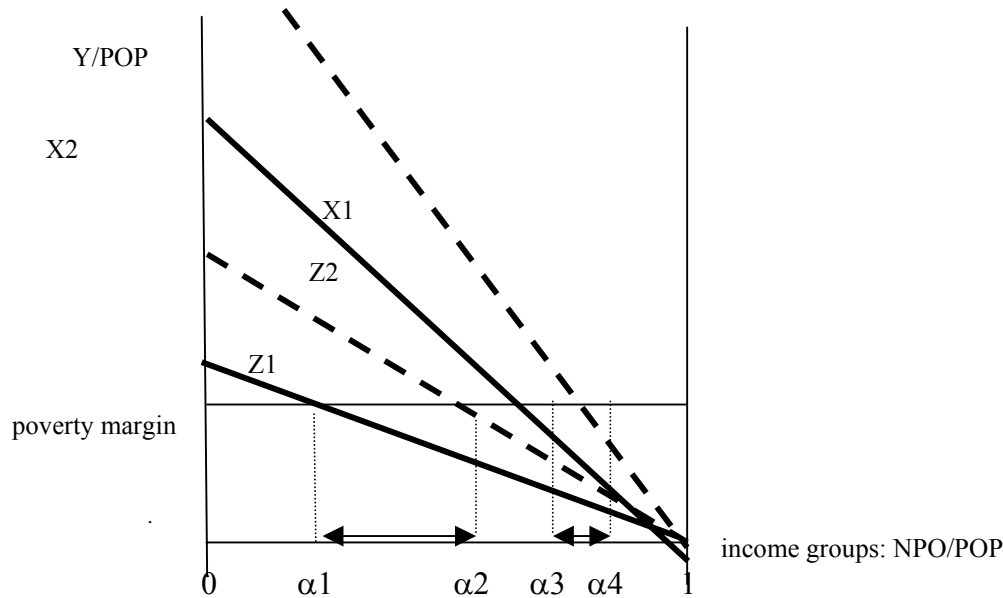
$$(1.3) \quad \Delta Y_p = 365 PO - Y_{dp} + g_m PO - G_p$$

The income gap can be closed by income generating activities of the poor (pro-poor growth) which is sufficient also to pay for the transfer- and services-gap ($g_m \cdot PO - G_p$), or by fiscal redistribution. The *public-goods gap* can be financed by a regrouping of public expenditures at the expense of cuts elsewhere, by tax increases due to higher tax rates or a broader tax base or growth-driven higher tax receipts; the gap can also be financed by public debt (from domestic or foreign sources) or by foreign grants.

The growth-poverty relationship stems mainly from the correlation between pro-poor growth of Y_p , tax receipts and general GDP growth. Pro-poor growth may be the cause for overall growth, or growth of non-poor income may cause the growth of the income of the poor via redistribution. Pro-poor growth generally corresponds to a growth of agricultural output.

If there were no growth-poverty linkage at all, during a process of growth, income distribution would continually deteriorate: The bottom quintile of the population would gain a continuously declining share of aggregate income. Apparently this happened in the US during the last two or three decades because of increasing income differentiation. In a totally dualistic economy there is no linkage between the poor and the non-poor sectors. In a completely non-monetarised poor sector (subsistence sector) in a LDC this can potentially occur. Although almost all LDCs are dualistic economies, such a sharp divide seems unrealistic. There do normally exist *some* market linkages via the sale of agricultural products and the purchase of consumption goods and personal services by the rural population from the poor sector. And there is also the possibility that higher tax revenues and transfers may improve the situation of the poor.

The poverty-growth-relationship can be demonstrated by figure 1.1, which shows the per capita income (Y/POP with POP as population) of different income groups. The line X1, for example, shows the richest 1% of the population with a per capita income of let us say 1 million Euro, the second 1% of the population with 0.9 million Euro and the last 1% with 1,000 Euro. Given the poverty margin, the figure shows the ratio of the non-poor (NPO) to the population, i.e. NPO/POP . In the case of the line X1, the proportion of non-poor to poor is given the ratio of α_3 to $(1-\alpha_3)$.

Figure 1.1: Per capita income and poverty share of the population in country X and Z

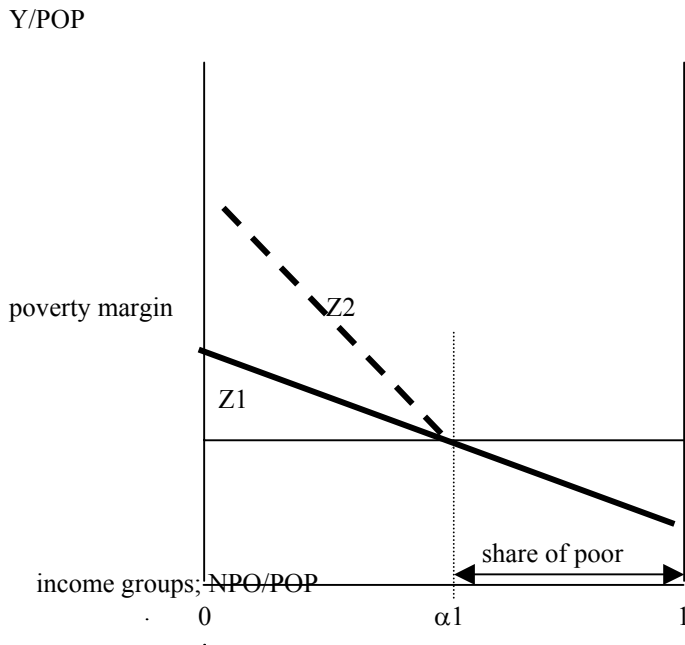
The figure represents the case of two countries. Country X has a low share of non-poor while country Z has a large share of poor. What is important in our example, however, is that country Z has a more equal income distribution – shown by the relatively flat income-distribution curve Z1 – than country X, as shown by X1. Now let's assume that, during a given period, both countries have the same overall growth rate and that in both countries all income-groups get the same *relative* benefit (as a per cent of the respective income) from the increase in income. Now for both countries the income-distribution curve rotates to the right, from X1 to X2 and from Z1 to Z2. In country Z the relation of non-poor to the population is substantially reduced by α_2 minus α_1 , whereas in country X it is reduced by only α_4 minus α_3 . Obviously, in country Z growth decreases the number of poor much more than in country X. The conclusion is that growth reduces poverty more – provided that all income groups benefit equally in per cent of income from growth – if there is an equal income distribution as compared with a situation where incomes are distributed more unequally.

It also becomes clear that a negative growth rate in a poor country with relatively equal income distribution increases the poverty ratio (PO/POP) dramatically (a shift from Z2 to Z1). If there is an extremely unequal income distribution in a poor country, poverty becomes rather inelastic with respect to growth (country X), and special pro-poor-programmes are necessary.

Short-term growth rates, e.g. for only one or two years, will probably not have much impact on poverty reduction, but if growth rates are sustained for several years the impact might increase. For example, growth of 7% for a sustained period can have a much more substantial impact on reducing poverty than a previous growth rate of 2 or 3 %. That means that a long-term sustainable growth process has to be initiated to reduce poverty significantly.

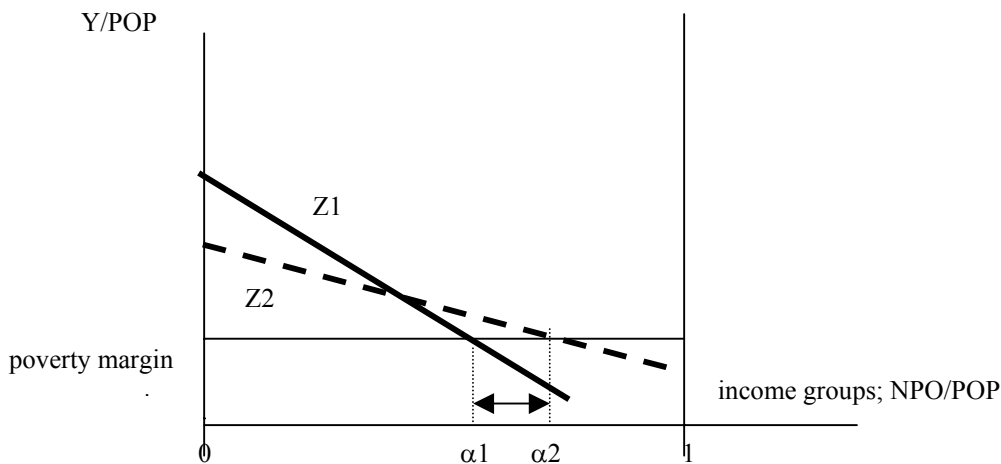
The case of a completely *dualistic economy* can also be illustrated. In such an economy, income growth affects only the non-poor, so the income-distribution curve shifts only in its upper left part whereas the poor in the right part remains unchanged. In figure 1.2, only the richer gain from growth – from the shift from Z1 to Z2. In spite of growth the number of poor does not decrease.

Figure 1.2: Per capita income and poverty share of the population in a dualistic economy



Finally the effect of a redistribution by the tax system, government transfers etc. can be shown. In figure 1.3 we start with the income-distribution curve Z1 and a relation of NPO/POP of α_1 . Redistribution - without any growth - will make the income-distribution curve flatter and will reduce to number of people defined as poor. Z1 rotates to Z2, and poverty drops to $1-\alpha_2$.

Figure 1.3: Per capita income, poverty share of the population and redistribution



How do macroeconomic imbalances like inflation or deflation, current account deficits, and high budget deficits influence poverty? Are there any direct links?

Inflation above around 10 per cent (see below) hampers growth by triggering restrictive macro-economic policies; such policies lead to lower growth and normally imply fiscal austerity which directly impacts on public goods that benefit the poor. Undoubtedly disinflation and austerity normally hit the poor. Whether they hit them more than the rich in percentage points is a statistical detail, since the social impact on the poor is certainly much greater. Persons without (or with very little) money income also suffer from high inflation if access to public goods is impaired. However, in the case of the poorest groups, whose money income is negligible, and who do not have any access to public goods facilities, inflation and austerity do no harm. But their chances of improving their status becomes worse.

Current account deficits and foreign indebtedness tend to precipitate devaluation, often accompanied by financial crises with negative growth. Again, this impacts poverty via the growth performance and the budget constraints. If financial crises can be prevented, but foreign debts increase steadily, the burden of interest payments for the public budget increases and tends to crowd-out pro-poor expenditures. The same applies to high and sustained budget deficits. Tax increases will, in most cases, also hurt the poor, and expenditure cuts even more so. Theoretically, pro-poor public outlays could have a positive impact, but under normal circumstances the political pressure of the poor is weak.

Summing up, growth is directly and indirectly important for the poor, as is redistribution by fiscal policy. Both are necessary and one should not count on a trade-off, especially if a minimum amount of pro-poor public goods is not provided. There is no question that macroeconomic imbalances of the type mentioned are harmful for the poor. The key question is not the growth-poverty relationship, but how to improve growth. Here we disagree with much of “chapter 6”.

2. Theoretical Foundations for the Analysis of Poverty and “Underdevelopment”

Although “chapter 6” does not aim to outline a coherent theoretical basis to analyse the macroeconomics of poverty reduction, it refers directly or implicitly to a firm set of theoretical propositions which are well-known and have long been discussed in macroeconomic theory and development economics. This basic economic philosophy is used in many parts of the paper, and it leads and underpins the empirical arguments as well as the interpretation of empirical data. However, there is no clear-cut theoretically based thread in the paper. Basic propositions applied in “chapter 6” are highly controversial in the macroeconomic discourse, and these controversies cannot be obliterated by hinting at empirical investigations.

Four crucial themes will be reviewed in this section: (a) the unclear feature of “macroeconomic stability” and its implications; (b) the causal relationship between saving, investments and economic growth; (c) the claimed linkage between allocational improvements and growth performance; (d) the assertion of a shortage of capital or finance conceived as a key factor causing underdevelopment. All four propositions have far reaching political consequences and are by no means of merely academic impact.

2.1 A More Comprehensive Understanding of “Macroeconomic Stability”

The term “macroeconomic stability” in “chapter 6” is inadequately defined. In fact the notion of stability is employed in two ways that are not congruent. Furthermore, we have a much stricter understanding of macroeconomic stability, and there are different opinions about the role of active macro policies.

First (see World Bank 2000, box 2, p. 5), macroeconomic stability means “a situation with key economic relationships ... in balance - for example, between domestic demand and output, the balance of payment, fiscal revenues and expenditures, savings and investment.” The notion of firm thresholds for these variables is, rightly, rejected, so that a substantial “grey area” exists. Of course, it would be essential to identify the key relationships and the balances required. The examples mentioned are either tautological (savings and investment, an *ex post* identity), imprecise (output and domestic demand, what about exports and imports?), or vague and ambiguous. The most prominent measure of stability, namely price stability, is left out, likewise employment, growth or the sustainability of indebtedness. Widespread poverty apparently is a phenomenon which can coexist with macroeconomic stability in this sense.

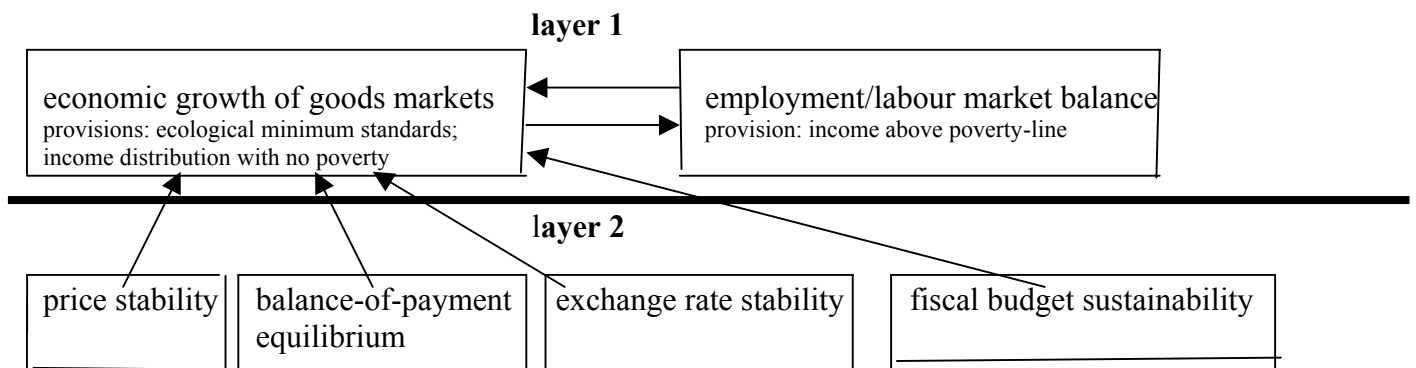
The second approach is mentioned in section 3.1 (World Bank 2000, p. 8): here, instability is seen to be caused mainly either by “exogenous shocks” or by “inappropriate policies”, and stability is taken to mean the mere absence of these two factors. In this context, what constitutes inappropriate policy is not mentioned, although this is essential: since exogenous shocks can hardly be avoided (within the discretion of a poor country), everything hinges on the definition of the appropriateness of policy, although the latter is to be derived from the over-all requirements of macroeconomic stability. The authors get trapped in a tautological circle. This “definition” obviously implies, in the absence of exogenous disturbances and inappropriate policies (which are also exogenous with respect to markets) that everything will be in balance and equilibrium: it assumes implicitly the stability of the private sector. This, of course, is an unproved axiom.

What is the baseline out of this seemingly untidy use of the term? It is clear-cut: in the absence of exogenous shocks, macroeconomic stability will emerge automatically, if appropriate policies are conducted. Then there will be no trade-offs, and everything will be in harmony. The policies should prevent extreme imbalances in the above mentioned areas or keep the imbalances within the “grey area”. As explained in detail below, the allocation of productive factors will automatically yield growth and lower poverty. *Active* and *expansive* macroeconomic policies, or structural policies, are not considered necessary or they are even conceived of as enhancing instability. In this approach, there is no case for employment policy, as an important part of macroeconomic instability-reducing strategies, although poverty and employment (in the market sector) are closely related.

All in all, the essential term “macroeconomic stability” seems to be a more or less empty phrase. However, this is truly not so.

Here an alternative approach to analysing macroeconomic stability in LDCs is sketched. We start with five macroeconomic objectives which should be achieved by markets combined with adequate governmental policies when necessary (see figure 2.1). Only if an adequate balance is achieved between these objectives can we speak of macroeconomic stability. Between the six macroeconomic aims there may be trade-offs and also reciprocally reinforcing linkages. To be more precise, there are two groups of targets – the upper layer directly relates to quality-of-life aims, and the lower layer concerns the key macroeconomic balances. Some of the aims have to be considered as preconditions for the others. For example there is no trade-off possible between relative price stability and relative stable nominal exchange rates and other aims. The basic development problem is how to combine the aims in layer one with the aims in layer two.

Figure 2.1: The two-layers of macroeconomic stability



- *Economic growth* refers to sustainable per capita growth measured by real GDP, providing minimum ecological standards. The second provision of growth is, that it should include *income growth of the poor* or the prevention of income reductions below the poverty line. One might also stipulate that minimum ecological standards should be coupled with minimum income standards which ultimately guarantee the absence of income poverty. Growth can be directly pro-poor growth or mainly income growth for higher income brackets with appropriate redistribution mechanisms. Growth is therefore not necessarily confined to direct pro-poor growth. Furthermore, calling for growth does not necessarily mean striving to maximise growth. More important is that growth is sustained, and therefore that economic crises and stagnation are prevented. This growth target implies sufficient demand (domestic and foreign) on a *dynamic* non-inflationary path.

- The *employment objective* refers to a balance of the supply of and demand for gainful employment at a wage that is above a minimum level of real income defined by anti-poverty standards. Thus the minimum wage should be equal to or higher than the subsistence level.

In this context, subsistence should not only refer to non-monetary parts of the economy, but also to money- and non-money-income plus access to education, water, health services etc.

Employment and per-capita income growth, including the social and ecological provisions mentioned, are the direct quality-of-life related macro-economic objectives, whereas price stability, balance of payment equilibrium and the sustainability of the fiscal budget describe economic conditions necessary to achieve the first group of targets.

- There is a broad consensus that *price stability* should be understood in a functional way: inflation rates above 10 per cent are not sustainable and are detrimental for growth and employment, whereas inflation below this threshold is not dangerous, but strong price discipline might be at the cost of a trade-off with growth and employment. In addition, of course, deflation is unwanted. On this point we accept the arguments in the sourcebook (World Bank 2000).
- The *balance of payment* can be conceived as a macroeconomic budget restriction. A sustainable development path implies that an economy cannot buy more than it can afford or pay for, if financial crises and over-indebtedness are to be prevented. Financial crises normally lead to at least a series of devaluations which weaken the quality of the currency, induce capital flight, inflation, real appreciation of foreign debt, a diminished fiscal margin for pro-poor activities etc. Therefore, macroeconomic stability requires the absence of over-indebtedness. Grants can play an important role in preventing the build-up of foreign debt. The current account constellation should be used to stimulate domestic growth. It has by no means been proven that current account deficits influence growth positively. The sourcebook is not clear on this point. The argument in favour of a more or less balanced current account, or, even better, a current account surplus is given in detail below (section 6).
- *Exchange rate stability* is a core part of macroeconomic stability. Exchange rate stability in the sense used here does not imply permanently stable exchange rates: no doubt, overvalued currencies must be devalued – once. After devaluation, stable exchange rates are an important source of macro stability.
- The *fiscal balance* of the government budget is the second budget restriction of macroeconomic significance. High or rapidly increasing budget deficits are not compatible with fiscal sustainability, and they can induce demand inflation. This judgement does not call for a balanced budget, neither in the short nor in the long run. However, deficits must be sustainable, which allows for short-run deviations, and they must be in balance relative to growth and public investment. For further details see section 5.

The interactions between the two layers of macroeconomic stability must be taken in consideration. The key point is this: if the four balance targets of the lower layer are realised, there is *no direct link* to the targets in the upper layer. All depends on the sources of growth. Macroeconomic stability in respect of the four lower targets is necessary, but not sufficient for *dynamic* macroeconomic stability, which is much more ambitious but necessary for poverty reduction. The key problem for underdeveloped countries is how to move from appropriate policies in respect of inflation and sound fiscal policy to growth. In many cases governments guarantee stable price levels and exchange rates and reduce budget deficits – but there is no growth.

”How to come from stabilisation to growth?” – this was the question asked by Dornbusch (1990). He rightly points out that governments become the proverbial king without clothes if the price level, exchange rates and the budget are right but investors follow a wait-and-see attitude and do not invest (Dornbusch 1990). Without growth in the long-term there is the danger that price stability, fiscal balance, exchange rate stability and even political stability cannot be sustained. We therefore argue for a broader understanding of macroeconomic stability which embraces both layers of targets.

Some might question the relevance of the lower-layer macroeconomic balances for poverty reduction since in many LDCs the poor live mainly in the non-monetary subsistence sector. However, if the definition of poverty includes access to infrastructure, health services, education, etc., these public (or semi-public) goods concern the monetary economy, mainly through the budget, although also through certain market-production sectors. It should not be forgotten that there are many linkages between the non-monetary and the monetary sectors of LDCs; therefore macroeconomic stability, even in the narrow sense, matters also for the subsistence sector.

2.2 Saving and Investment in a Closed Economy – Some Critical Comments

In numerous parts of ”chapter 6” the following propositions are explicitly or implicitly applied:

(i) Investment and growth are strongly correlated, and investment is implicitly regarded as depending on microeconomic conditions, mainly on allocational efficiency. (ii) High saving leads to investment and growth, provided macroeconomic conditions are in balance. (iii) Since the savings quota of richer people is higher than that of the poor, more income equity might lower saving, investment and growth, although recent empirical studies cast some doubt on these relationships. (iv) Budget deficits crowd-out private investment which is regarded as the engine of poverty reduction.

(ii) We agree that investment and growth are strongly correlated; investment (by private or state-owned enterprises, public infrastructure investment included) is indeed the engine of growth. However, the determinants of investment are manifold, including microeconomic criteria. Taking investments as a macro aggregate, excluding public investment, they mainly depend on profitability expectations with regard to alternative ways of using one’s assets, namely interest rates, which largely depend on macroeconomic conditions. Profitability expectations are collective or inter-linked individual expectations, based on subjective probability estimations in an uncertain world. We agree with the argument in the sourcebook that high inflation and exchange rate instability increase economic uncertainty and destroy any incentive for private investment. Private profit-oriented investments are subject to public policies insofar as the latter can influence (i) demand, (ii) interest rates, (iii) the structure of incentives and impediments and (iv) the degree of uncertainty. To a certain extent the investment performance of an economy can be influenced by macroeconomic policy, by institution building and by adequate structural policies. Unfortunately, there is no clear mechanical relationship between a certain set of economic variables and investment; investments ultimately depend on the behaviour of entrepreneurs and their financiers which is hardly predictable. The linkages between allocation, investment, and growth will be scrutinised in the next section.

(iii) In a market economy there is no causal relationship from saving to investment, although this is claimed in traditional neoclassical theory and in some postkeynesian theories, mainly in Harrod-Domar-growth theory.³ Current saving is a decision not to spend money income for consumption or for investment now, so it lowers demand, output, and aggregate income directly. The decision not to have lunch today gives no incentive for the restaurant owner or any other entrepreneur to invest today, as saving impedes the preparing of a dinner today without stimulating the business of making ready for some future consumption (Keynes 1936, p. 210). The neoclassical paradigm supposes that there is a market for saving and investment and that higher saving will automatically reduce the interest rate and stimulate investment. Such a flow-market of loanable-funds does not exist. Investment, financing of investment and the interest rate are determined in an asset market with stock variables, not flows. Important is the portfolio decision of banks, entrepreneurs and households

Firstly, the amount of savings, conceived as the supply side of the credit market, is a stock variable, and additional current saving will add only very little at the margin. Increased current saving can induce additional investment, if long-term interest rates are subsequently lowered and if investments depend on interest rates. Lower consumption would be offset by more investment leaving aggregate demand constant. Here we can only offer a few basic objections to this loanable-funds theory, which is implicitly used in "chapter 6".

Secondly, central banking does not play any role in this notion of the credit market. If the central bank were to lower interest rates in order to expand the credit supply, additional investment might take place without further private saving prior to investment.

Thirdly, the necessary *ex post* identity of saving and investment (in a closed economy without government) can be realised without prior saving. If output and real income increase, a parallel *ex post* increase of saving follows. If high investment creates excess demand and increases the price level, then profits and saving by entrepreneurs will be higher. The first effect was stressed by Keynes (1936), the second one also by Keynes (1930) and by Schumpeter (1926).

Fourthly, investment can be financed by credit creation prior and independent of saving. The causal "from-I-to-S-chain" does not cause inflation if unemployed labour and investment or intermediate goods are available, or if capacity utilisation can be increased. If the complementary goods for investment must be imported, inflation can likewise be avoided, but GDP growth is diminished. In the event that a current account deficit occurs, foreign saving is necessary. Only if all domestic capacities are utilised and additional imports are not possible, can inflation occur, even if labour is available.

It should be clear that this is not the typical situation in poor countries. What is normally referred to as a Keynesian situation (unemployment and free capacities), seems to be rather characteristic of normality in LDCs. Technically speaking, most LDCs operate in situations below the production-possibility frontier.

³ The sourcebook argues in the following way: „To the extent that high income people save a larger proportion of their income than low income persons, policies that redistribute income in favour of the lower-income population may negatively affect sav-

Fifthly, in most LDCs domestic interest rates are highly dependent on foreign interest rates. Therefore, it is quite improbable that more domestic saving lowers domestic interest rates.

A closer link between saving and investment might occur if savers and investors were the same institution, e.g. if a firm invests with saved or retained profits or a private household builds a house financed with its own current or previous savings. But in these cases the investment decision is the salient point. Again, it must be emphasised that more saving immediately creates less demand and no stimulus to invest. Subsequently, real investment will be reduced (and inventory investments increased) as well as GDP and income, so that *ex post* saving and investment will be equal at a lower level. Thus, higher saving does not induce higher investment but rather lower growth.

(iv) No doubt the macroeconomic saving-income ratio can be increased by less income equality. Again, this redistribution will not necessarily lead to more investment. It might even result in less output if demand were reduced. In periods with high investment demand, high profits can be created which lead to a more unequal distribution and reinforce the investment dynamics. Again, the causal chain starts from investment. Summing up, more income equity can be associated with high or low investment or growth. There is no unambiguous empirical picture.

(v) The call for a balanced budget, or even budget surplus, is sometimes based on the hope of crowding-in private investment: Higher saving should lower interest rates (or expectations concerning the future tax burden) and promote investment. Some reinforce this line of argument by demanding lower taxes in order to increase private saving and private investment. This concept is based on one fundamental assumption: the amount of saving and of current output in the economy is a fixed quantity, which can be used by the government or the private sector. The more the budget absorbs, the less is left over for private agents. If private investment is regarded as the engine of growth and poverty reduction, then budget deficits as well as high taxation are detrimental for approaching this target. However, in this perspective the true relationships are completely distorted.

Budget deficits and private investment correspond to saving of households (equation 2.1 below in section 2.3). It was shown above, that interest rates are not determined by the interaction between current savings and investment, so, if the budget deficit is lowered, interest rates will not automatically decline. Instead, aggregate domestic demand will shrink as well as output. There is no reason why private investment should automatically compensate for budget deficits; in fact the opposite effect cannot be excluded, namely, that private investment shrinks because of lower aggregate demand. *Ex post*, current saving and output will be lowered. Even if budgetary demand for credits does have a noticeable effect on interest rates, interest rates will fall later than the budget deficit:

As soon as public expenditure is increased (or taxes lowered) due to higher deficit spending, aggregate demand increases too, creating – in a “Keynesian situation” – more output, more income, more saving. Saving as well as aggregate output cannot be perceived as a constant quantity.

ings and, to the extent that such savings are channelled into productive investment, long-term growth.” (World Bank 2000, p. 6)

Crowding-out (or –in) considerations should not be applied to the macroeconomic analysis of public deficits (or it should be confined to very special cases), irrespective of empirical tests, which generally do not support the crowding-out hypothesis. In respect to fiscal policy, the sourcebook avoids a clear answer. There are Keynesian arguments: „In this regard, it is important to note that there are no rigid pre-determined limits regarding a country’s fiscal stance (such as, for example, ‘the budget deficit must not be more than ‘x’ percent of GDP’“ (World Bank 2000, p. 12). However, at the same time S and I are seen in a neoclassical perspective.

If aggregate investment were limited by domestic saving and the latter could not be raised, it would seem desirable to use foreign savings, if available. Capital imports could be used as a means of achieving higher domestic investment and thereby higher growth. In this perspective *capital shortage* is regarded as the core of low development. In the following digression we reject this notion which has far reaching consequences for the balance of payment and the use of foreign finance for development.

2.3 Does Foreign Saving Augment Domestic Saving and Investment?

This section outlines some basic formal relations and definitions that sometimes seem to have been misunderstood or forgotten. It explains our proposition that foreign saving can increase domestic investments and growth only under certain very specific circumstances, whereas normally the adverse effects of capital inflows dominate.

The basic relationships

Following national income accounting, the sum of the balances of the different economic sectors must be zero (all variables are *ex post*). Whereas in a closed economy without the state, household saving⁴ S_H equals investment I , in an open economy, with the government included, we find: $S_H = I + G - T + Ex - Im$. $G - T$ is the budget balance with G as expenditures and T as tax receipts, $Ex - Im$ being the current account deficit, which is equivalent to the trade balance if there are no other balances in the current account. It follows that household savings plus the budget surplus (B_{sur}) plus the current account deficit (CA_{def}) minus private investment must be zero.

$$(2.1) \quad S_H + B_{sur} + CA_{def} - I = 0$$

In equation (2.1) the private household sector, the state and the rest of the world are surplus sectors, the enterprise sector is the deficit sector. Normally the enterprise sector is in deficit and the households are a surplus sector. The government sector and the sector “rest of the world” can be in deficit or in surplus.

There are typical constellations between surplus and deficit sectors. Many poor developing countries have both current account deficits and budget deficits (B_{def}).

In this case equation (2.1) becomes:

$$(2.2) \quad I + B_{\text{def}} = S_H + CA_{\text{def}}$$

According to equation (2.2) a higher current account deficit will lead to lower domestic savings, a higher budget deficit or higher private investment. Numerous constellations are possible within the mechanics of the balance constraints. Since these are *ex-post* equations they provide no indication of causation.

Different interpretations

As mentioned above, some economists – and traditionally the IMF and the World Bank - argue that in developing countries domestic saving is so low that current account deficits – that means foreign saving – will increase investment.⁵ The basis for the argument is the neoclassical belief that savings will be transformed into investment, and that too low household savings can be augmented by foreign savings and a current account deficit. However, as equation (2.2) shows, the relation between current account deficit and internal investment is not certain. It is possible for higher current account deficits to lead to lower household saving or to higher budget deficits.

According to Keynesian theory, as explained above, savings are the result of investment. For example, it is possible that higher investment will lead to higher output and lower budget deficits, more household savings and a lower current account deficit. In this case the nexus between higher foreign savings and higher investment does not exist. Higher investment may, on the other hand, induce higher growth, which results in more imports and an increased current account deficit. In this case the causation runs from I to CA_{def} .

The equations can also be used to show the potential effects of fiscal policy. If governments realise higher budget deficits – for example to help the poor – the current account deficit may increase. Further below we will discuss this point in more detail. It is also possible that higher budget deficits reduce private investment or increase household savings. The first argument is based on conventional neoclassical models. Higher budget deficits will lead to a crowding out of investment by inflation or higher interest rates. If the economic agents expect higher future tax-payments as a result of higher budget deficits, saving will increase by exactly the same amount as the budget deficit (Ricardian equivalence theorem). Under certain conditions the Keynesian approach also expects that higher budget deficits will lead to higher savings. If there are unused capacities, higher government demand increases capacity utilisation, production, income and finally savings.

⁴ We assume that enterprises do not save so that all internal saving equals household savings and budget surpluses.

⁵ The classical formulation of the import-led development strategy is from Chenery/Strout (1966). For a reformulation compare a recent statement by the IMF: "Capital-to-labor ratios in developing countries are lower than in advanced economies, and other things equal this relative scarcity of capital might be expected to make the return from investment in former higher than in the latter. In a world in which capital is free to flow in search of highest returns, there are therefore grounds for expecting that it might increasingly flow to developing countries where it can help boost income growth. These forces should work to promote productivity and income growth in developing countries and should therefore increase the likelihood of convergence." (IMF 1997, 78f).

It is useful to distinguish three sub-balances of the current account: the trade balance of exports (Ex) and imports (Im) including services ($TB = Ex - Im$), the income balance (mainly net interest payments) (IB), and grants given by donor countries and international institutions (DB). If the balance of current account (CA) is zero, any increase in interest payment must be compensated by higher net exports or higher grants. Higher grants, the balance on current account being zero and IB unchanged, will lead to higher imports or less exports.

$$(2.3) \quad CA = TB + IB + DB$$

Current account deficits/surpluses are only possible if there are net-capital inflows/outflows. Especially the analysis of current-account deficit countries makes it clear that the finance side determines the balance of current account. For example, in the year 2000, only net capital imports enabled the United States, Pakistan or Estonia to realise current account deficits, and only net capital outflows allowed PR China, Indonesia or Japan to have current account surpluses.

The composition of the current account deficit

A current account deficit equals private capital imports (PC_{Imp}) plus official capital imports by international organisations and foreign governments (OC_{Imp}) plus decreases in the foreign reserves by the central bank (FR_{dec}). Any reduction in foreign reserves can be interpreted as a substitute for other capital imports, any increase in foreign reserves as a substitute for capital exports. It follows:

$$(2.4) \quad CA_{def} = PC_{Imp} + OC_{Imp} + FR_{dec}$$

Obviously in the long-run a current account deficit is only possible if there are private and/or official capital imports. Short-run current account deficits can be financed by reducing international reserves – if there are any. A current account deficit will in any case reduce the international net-creditor position of a country or – if it is already a debtor – increase its international net-debtor position. Development aid in the form of grants are booked in the balance of current account and do not increase the debtor position of a country, whereas loans, including concessional loans, are booked in the capital account. This is an important argument in favour of grants in the field of development aid, as shown below in section 4.

Private and official capital imports have different forms: international bank credits, international debt securities issued by governments or enterprises, and sales of stocks and other real assets to foreigners. International bank credits and debt securities are denominated in foreign currency. This is at least the case for developing countries. Only the United States is able to build up foreign debt in its own currency. For LDCs it is dangerous to have debt denominated in foreign currencies since any devaluation of the domestic currency increases the real debt burden measured in the home currency.

If a currency devalues by twenty or even more per cent, the real debt burden will increase by the same percentage. No debtor is able to bear such shocks.

As developing countries with weak currencies in particular can never be sure that they will not suffer from exchange-rate shocks, any significant foreign debt is extremely dangerous, even if foreign interest rates are much lower than domestic ones.

Foreign direct investments (FDI) probably are the most favourable form of capital import as in this case the investor has to bear the risk of changing exchange rates.⁶ Normally they are not paid back like bank credits and only the transfer of profits to the home countries of the foreign investors occurs. But even if the investor wants to take the money back to his home country he has to accept exchange rate losses in the case of devaluation. Furthermore, FDI tend to be connected with technology transfers. On the other hand, FDI is normally aimed at the markets of the host countries, so it competes with investment by less competitive domestic firms, which might shrink. Thus FDI may not add to the overall investment of a country. FDI can also induce strong imports (investment and intermediate goods) thus leading to a deterioration in the current account, reinforced by profit transfers.

In the long-run current account deficits lead to the accumulation of debt which requires higher and higher debt-service (debt service = interest + redemption) payments. This necessitates increasing trade surpluses or higher current accounts deficits. If the debt has to be paid back, the current account deficit has to be turned into a current account surplus. Traditional development theory believed (or still believes) that after a period of capital imports, net resource inflows and the accumulation of foreign debt, the country will develop - initiating a “take-off” - and sooner or later reach the stage when it can pay back its foreign debt. Unfortunately, a different scenario is much more likely. After the period of current account deficits and the build-up of foreign debt, there is no take-off, but a debt-crisis. The latter can depress economic development for a long time and push a country onto a very low growth path. A debt crisis after a period of current account deficits is very likely, as developing countries are confronted with all kinds of shocks – internal and external. If such shocks lead to a stop in capital imports, or, what is more likely, to a sudden capital export, the country will be caught in a debt crisis. This will always be the case if the country has a high debt denominated in foreign currency.

There is another misunderstanding. In developing countries the lack of resources may be a problem – in developed countries as well. But development is more than the availability of resources. Development is, *inter alia*, the creation of an income-creation process, that means an investment-income creation process that generates savings as a result. To trigger-off such a process, foreign savings are not necessarily needed.

The baseline of this section is a simple message: foreign savings in the form of capital imports provide no guarantee that development will start. But foreign saving, especially in the form of foreign credit, will always create a fragile situation for a country. Foreign debts imply heavy risks. There are countless examples of LDCs relying on foreign savings but running into severe indebtedness traps.

⁶ If an investor has less than ten percent of the equity of a company, it is considered to be a portfolio investment. If the ownership is more than ten percent it is classed as FDI.

The current account and aggregate demand

Net domestic product (NDP) equals net investment, private consumption (C), government demand (G) and exports (Ex) minus imports (Im).

$$(2.5) \quad \text{NDP} = I + C + G + \text{Ex} - \text{Im}$$

The right side of equation (2.5) can be interpreted as aggregate demand and the left side as aggregate supply. Equation (2.5) can be used to understand different constellations.

If investment, consumption demand and government spending are presumed as given, any increase in the current account deficit that is caused by a reduction of exports or an increase of imports will reduce the net domestic income respectively production. Any increase of exports will, *ceteris paribus*, increase domestic production.

This shows how questionable the traditionally stipulated relation between foreign savings and internal growth is. If production in a country is restricted by demand, then it follows: Higher foreign savings or a higher current account deficit will lead to lower domestic production. Current account deficits of developing countries stimulate production and employment in the rest of world, not the other way round. For decades, especially Germany but also Japan – to mention just two examples - have been following a strategy of stimulating internal growth by means of current account surpluses (that means giving domestic saving to other countries). The best strategy for a developing country is to establish a constellation of export-led growth. Development aid should try everything to help LDCs to achieve such a constellation.

There are cases where foreign savings can be helpful without adverse consequences: This is the case if foreign grants are donated and used to finance imports of goods and services that cannot be produced domestically⁷ and which therefore do not reduce internal demand. This is neutral with respect to the current account balance and to exchange rates, and it does not increase the foreign debt, inflation or the budget deficit. Even in this case, foreign savings in the form of grants only lead to domestic investments if the imported goods are used as investment goods. Whether aggregate domestic investment increases depends on whether domestic investment is substituted or not.

Of course, the grants should not be used to substitute foreign goods for domestic ones, although this might be tempting. In this case the grant will stimulate foreign production and at the same time reduce internal production. Another case for foreign capital inflows are FDI, as mentioned above.

Some empirical facts

It is well known that countries like Taiwan with high and sustained current account surpluses have developed more successfully than most LDCs.

⁷ To be more accurate: These goods cannot be produced at competitive prices calculated with shadow exchange rates which are capable to equilibrate the current account.

The IMF has recently generalised the relation between the current-account situation and development (c.f. table 2.1).

Table 2.1: Development and Current Account Deficits, 1970 - 1998

Country groups	Current account deficit as per cent of GDP
<i>Low-income countries</i>	
Negative growth	6.5
Slow growth	8.6
Slow convergence	3.1
Fast convergence	0.7
<i>Middle-income countries</i>	
Negative growth	3.1
Slow growth	4.5
Slow convergence	3.5
Fast convergence	1.7

Source: IMF (2000, p. 113)

Table 2.1 shows that the country groups with the lowest current account deficit have had the best long-term performance. And this is the case for low-income countries as well as for middle-income countries. Countries with negative and low growth had the highest current account deficits in both groups. These facts seem difficult to explain if one believes that foreign savings help to develop domestic development.

2.4 Why Improved Allocation Does not Trigger off Economic Growth

”Chapter 6” argues that macroeconomic stability (in the narrow sense of the absence of exogenous shocks and with macroeconomic imbalances held below critical margins) is important but not sufficient for economic growth:

”In most cases, sustained high rates of growth also depend upon key structural measures, such as regulatory reform, privatisation, civil service reform, improved governance, trade liberalisation, and banking sector reform ...” (World Bank 2000, p.2)

”Studies show that growth is driven primarily by private sector capital accumulation. Therefore, a key objective of a country’s poverty reduction strategy should be to establish conditions which can further facilitate private sector investment. ... It will certainly include increased and more efficient public investment in a country’s human capital in areas of health, education, and other priority social services.” (World Bank 2000, p.4)

What is called ”structural measures” can be understood, on the one hand as an improvement in the allocation of productive factors, and on the other hand, as institutional reforms and better governance. However, the two aspects are not properly differentiated by the authors of the sourcebook.

The logic behind the proposition in the first meaning of “structural measures” is that increased allocational efficiency leads closer to a Pareto optimum, provided there are no exogenous shocks and extreme macroeconomic disequilibria. This idea is typical of orthodox neoclassical thinking⁸ as well as traditional IMF/WB structural-adjustment programmes. One might call it the implicit growth theory of the IMF/WB. We reject this relationship: There is no direct link. Better allocation *can* lead to higher or lower investment and growth; it can even increase poverty. Better allocation will improve *microeconomic* efficiency, but this will by no means guarantee macroeconomic efficiency or higher investment rates. Better allocation may lead to static gains (once-and-for-all effects), but not to higher growth. Of course, we do not object to allocational efficiency improvements. But if this is supposed to be *the* engine of growth *and* poverty reduction – it is the wrong engine driving other forces but not capital accumulation.

”Structural measures” or allocational improvements, as we summarise this generic term, comprise the following five elements, all of them being of microeconomic nature (see figure 2.1):

Abolition of price distortions (”getting the prices right”) in order to create a system of competitive prices indicating the scarcity of factors and goods. Subsequently, marginal costs will determine prices, the marginal productivity of labour/capital should determine wages or profit/interest rates. And, since world market prices are the benchmark for competitive prices, domestic prices should correspond as much as possible to world market prices.

Getting the prices right implies *competition*. So structural measures are competition enhancing devices, busting monopolies and monopolistic rents, increasing international competition, abolishing subsidies which maintain uncompetitive production etc. It is a call for liberalising markets in order to free market forces, so that producers will be encouraged to explore unexplored chances and move away from unprofitable businesses. Therefore, relative prices of goods and factors will be changed during a transition period of structural reforms until they are in a state of being ”right”. Changed relative prices will lead to structural adjustments in the sense of different sectoral, regional and production-technique related structures. Improved allocation induces structural change which implies the destruction of uncompetitive production and the creation or enlargement of competitive output. In any case, during the structural reforms painful adjustments are inevitable.

Reform of property rights: these are to be defined and secured, and public property, which is considered to be basically unclear and to support inefficiency, is to be privatised. This may be regarded as a part of the institutional reforms. Since the privatisation of property rights is supposed to create strong private incentives for the exploitation of additional profitable production, it is regarded as a centrepiece of the growth and investment generating machine.

Provision of public goods: As far as there are products and services with strong positive external effects which cannot be internalised, public goods must be financed by the government and the taxpayers.

⁸ The argument is based on the same static equilibrium logic as the backbone of the microeconomic branch of neoclassical theory. The assumption is that all factors of production are fully used and the only problem is to increase their efficiency. The argument leaves no room for expectations and finance that are important for investment and no room for demand factors. It shows a deep belief in Say’s law.

This concerns mainly human capital formation and infrastructure (including education, health services, water provision, security facilities etc.).

Institutional reforms may overlap somewhat with allocational improvements, but they are much more basic and general and they should not be regarded as part of the allocation enhancing reforms. Such measures include nation-building, the initiation of a division between state and economy with an independent government, the development and initiation of a legal structure which guarantees the making of contracts; the development of entrepreneurial attitudes favourable to capital accumulation; a reduction in the degree of uncertainty for contract-making agents; the shaping of governmental institutions which implement and secure the above mentioned reforms and which smash the old structures, guarantee "good governance", embark on parliamentary democracy, enable civil society to participate, combat corruption, prevent military struggles etc. In short: the formation and strengthening of a developmental state.

In recent years the World Bank has rightly emphasised the impact of such institutional reforms; but this approach is quite different from the allocation-based approach to development and growth. In "chapter 6" both approaches are mixed up. In the following we concentrate on the critique of the traditional notion that allocational improvements can induce growth.

Figure 2.2: Improvement of allocational efficiency – the meaning of "structural reforms"



Let us assume the proposed reform package is adopted and completely implemented by the governments of some poor LDCs. What happens? We argue in three steps analysing the process of reallocation, and the employment and investment consequences.

The process of reallocation

We can observe a process of reallocation where some production vanishes and some new or additional production emerges. The structure of the economy changes thoroughly. Nobody can know whether production increases will outweigh production losses. GDP may stay constant with a new composition, it may increase or decrease. There is no reason why aggregate investment should necessarily be higher after structural transition. But let us, arbitrarily, assume aggregate investment and GDP do increase. After reallocation, the expansion will cease. Pareto optimum is reached. By definition of the Pareto optimum, GDP cannot increase further.

Growth is impossible unless some data or constraints change, like technical progress (e.g. technology transfer from outside, or due to improved human capital) or increased population (which, however, does not yield higher per capita growth).

One might object, that allocational reforms require a long period with piecemeal steps towards the optimum, thus contributing year for year to higher growth. But, we repeat our assumption that the relation between better allocation and growth is arbitrary. There is plenty of evidence that privatisation increases productivity and lowers employment, that liberalised trade destroys domestic production which had previously been sheltered, that free-market prices for grain can prove to be too low to set positive incentives for farmers, and so on. In many cases reallocation due to structural reforms will result in productivity hikes and/or unit cost reductions. Undoubtedly this should be praised as efficiency enhancing microeconomic reforms – but there is no linkage to GDP growth, more employment or higher investment.

What happens to employment?

When there is unemployment, the traditional neoclassical model links falling real wages with increasing employment. According to this argument, unemployment is the result of a distorted system of relative prices. If there is unemployed or underemployed labour, maybe also in the subsistence sector, market forces, so runs the argument, will detect chances for profitable additional employment and output if real wages are flexible downwards. Under this condition either the existing stock of capital will be combined with more labour. The given stock of capital consists of land and man-made physical capital, the former being the major part in poor, agricultural economies.

Suppose capital, including land, can be combined with labour at any ratio. Neglecting technical progress, the neoclassical model assumes diminishing marginal productivity when more labour is employed, *ceteris paribus*. If real wages decline in accordance with decreasing marginal productivity, we will sooner or later reach a threshold where real wages fall below the poverty line. Labourers will prefer subsistence labour, beyond the market sector of the economy. In this case, the market economy fails and people get stuck in poverty. Note that we have assumed flexible real wages, not only for the additionally employed labourers, but as regards the wage level for all workers since we have wage competition on the labour market⁹.

In an economy with money, money wages determine nominal wages. Consequently, a fall in the level of nominal wages will result in a falling price level and unchanged real wages (see equation 3.1 below). We do not accept that it is possible to achieve flexible real wages because we believe that only nominal wages can be determined in the labour market and that domestic goods prices will, more or less, follow unit wage costs.

⁹ The above developed model explains permanent unemployment in LDCs using the most simple neoclassical model. But this simple model needs extremely unrealistic assumptions. The stipulated relation between real wages and labour demand applies only to an economy with one capital good. In a general model with more than one capital good even within the neoclassical approach the relation between falling real wages and increasing employment does not exist. Falling real wages can increase or decrease employment. This is the result of the so called (and very often forgotten) Cambridge-Cambridge-debate (see Samuelson 1966, Heine/Herr 2000).

This implies that real wages cannot be lowered in accordance with the decreasing marginal productivity of labour even if flexible nominal wages with perfect competition on labour markets did exist. The adjustment process which was supposed to yield higher employment and GDP does not appear to be valid.

Does investment increase with effective reallocation?

How about the relation between better allocation and capital stock increases or investments? Entrepreneurs will only invest,

if they expect profits to be higher than with alternative capital outlays, e.g. on foreign stock markets, allowing for compensation for additional risks and uncertainties,

if they find reasonable credit opportunities (with interest rates that are not higher than expected returns from the productive investment) which requires creditors' belief in the credibility of the debtor,

if the investors are ready to accept the respective entrepreneurial risks and contingent uncertainties.

Expected profits also depend on many factors that are not so narrowly defined. For example, entrepreneurs will only invest if they expect sufficient demand for their additional output, or if they feel sufficiently competitive, although they do not really know how competitors will behave.

Of course, one of the most basic assumption in LDCs is that there are profit-oriented entrepreneurs with a preference for capital accumulation. If investment (especially in small businesses) is financed out of past profits, a preference for investment over consumption or the distribution of income among the family or constituency is necessary. Nothing guarantees that, even in the case that there are allocational efficiency gains, such gains will not be used for additional consumption.

If there is no shortage of entrepreneurs with capitalist behaviour and rationale, investment depends to a great extent on *positive expectations* and a low degree of uncertainty (the absence of which is normally not very conducive to investments), let alone interest rates, the procurement of finance etc. Only if positive expectations and sufficient finance exist is it possible to achieve a full use of resources, and to reach the boundary of the production frontier and to move for-ward on a stable growth path. Such constellations do not exist in the majority of LDCs, otherwise they would have no development problem. The entrepreneurial decision to invest is embedded in a complex process tied to many prerequisites; it is not a mechanical reflex to improved allocation.

Some of the proponents of a close allocation-growth nexus admit that during structural reforms short-term setbacks in output may be possible and they concede that (if GDP and poverty correlate) poverty may rise. But, they claim, in the *long run* a higher growth path can be reached. What forces should improve the situation?

The traditional answer is that the expansive counter-forces start if supply-side profit incentives become strong enough: if real wages shrink sufficiently, if prices decline, if privatisation takes place, if price subsidies are reduced etc. Khan and Knight (1985), for example, argue that a typical IMF demand-management package to achieve macroeconomic stabilisation will reduce growth in the short-term. In the medium-term the country will go back to its old growth path. But if the stabilisation is combined with improved allocation the country will jump on a higher growth path¹⁰.

Modern neoclassical authors use the argument of *rational expectations*. According to the rational expectation school, agents base their expectations on fundamentals and know the future in an objective-probability based way. Optimal (or improved) allocation would change expectations in a positive way with the beneficial consequences of higher investment. But is it not a presumptuous notion that economists know what thousands of individual entrepreneurs believe to be rational? A more realistic and modest attitude would be to claim that we do not know much about the long-term expectations of investors which are of fundamental importance for investment. So in spite of “optimal” supply-side packages an upswing may not occur.

Competitive reallocation and „macro prices“

If we embark on “structural reforms” with competitive reallocation, price flexibility is enhanced. This relates to all prices. But there are some prices with a strong macroeconomic impact: wages, interest rates, exchange rates. At first glance they look like normal prices, like the prices for tea, bananas or machines, seemingly microeconomic variables. However, these three prices have a special macroeconomic impact: as an original production factor the price for labour – the wage level - is the most important cost factor and thus heavily influences the price level (unlike the price, let us say, for bananas); interest rates as the costs for credits or capital procurement as well as a benchmark for the profitability of production; exchange rates as the valuation of domestic currency against other currencies, with high impact on the price level, competitiveness and profitability of domestic production, balance of payment, indebtedness etc. All three prices are partly influenced by policies, both domestic and foreign: monetary policy normally controls short term interest rates which impact to some degree on long term interest rates; exchange rates are influenced (or can be influenced) by the choice of the currency regime, by interest rates etc. Nominal wages are to a lesser degree subject to public intervention but are in most market economies influenced by specific labour market institutions such as, for example, collective bargaining processes. But minimum wages, reservation wages (determined by social policy, transfers to poor households etc.), wages in the civil service, employer-employees relations, all this may exert some influence on the (nominal) wage level. As only nominal wages are determined in the labour market, in no country of the world are real wages the result of wage contracts.

But real wages are influenced by inflation and stabilisation policies in order to control inflation. We call nominal wages, nominal interest rates and nominal exchange rates “*macro prices*”.

¹⁰ „The output costs can be reduced significantly if appropriate supply-side measures are introduced simultaneously with the demand-side package. Assuming that these supply-side policies raise investment and thereby the country’s trend growth rate of capacity output ..., the actual growth rate would also start to rise.” (Kahn/Knight 1985, p. 22) They openly commit: “No attempt, however, has been made to specify exactly the measures that would produce the result.” (p. 22)

One might contend that these special prices with high macro impact should, nevertheless, be regarded as normal prices subject to competitive market forces. This would imply that these prices should be liberalised in the same way as all other prices: wage flexibility should be secured, financial repression should be abolished, foreign exchange markets should be freed and full capital convertibility should be guaranteed. Behind such a vision to stimulate development is the neoclassical idea that the core of the market process consists in the play of *relative prices*. Following such a logic the price of labour - the real wage -, the price of capital – the real interest rate as the outcome of intertemporal barter exchange – and the real exchange rates are part of the system of relative prices. Money as a “veil” has to be removed to understand this interplay of relative prices.

However, *relative* prices and *absolute* prices – the nominal wage rate, the nominal interest rate and the nominal exchange rate – have to be distinguished sharply. Getting the prices “right” for these macro-prices is very different and much less clear than it is the case with relative prices. Normally price flexibility, in a partial analysis of specific markets with *ceteris paribus* conditions, will enable market equilibrium to emerge: supply will balance demand. But for the three macro prices it is not useful to follow such a partial equilibrium approach. What are the “right prices” for labour, capital, and currency? Nominal wage flexibility does not ensure full employment, it can also lead to deflation or inflation, and, more significantly, to poverty. Liberalised interest rates are still dependent on monetary policy, leaving aside foreign influences. Furthermore, if credit and capital markets are thin and underdeveloped, there will be no clear and stable equilibrium price. Exchange rates tend to be rather volatile in a fully liberalised regime, which can cause permanent shocks to the real economy. Full liberalisation of these three macro prices can produce macro instability. Thus fast liberalisation of these “macroprices” especially in LDCs can result in heavy macro imbalances, like inflation or deflation, the volatility of interest and exchange rates and economic chaos.

Above all, the impact of non-market institutions, first of all the central bank, on two of these prices – interest rates and exchange rates – is neglected and excluded. In other words, to attain the “right” macro prices, macroeconomic policies are inevitably involved. One of the main objectives of macropolicies should be to protect these prices from volatility: rapid changes in one or the other direction, with flexible nominal wage levels, price levels and nominal exchange rates, destroy the coherence of a market economy with extremely negative effects for investment, growth and poverty.

Summing up: Extensive liberalisation of the “macro prices” can result in macroeconomic instability. And macro instability is detrimental for investment and growth.

Growth and investment under sub-optimal allocation

Decisions about investment are largely independent of the degree of optimality of allocation of resources. To a certain extent this is even true for institutions. All this may cause inefficiencies, a distorted distribution of income and assets, and a misallocation of scarce resources. However, under such circumstances high growth rates and strong investment is possible over long periods.

It is by no means solely a short-run phenomenon that inefficient structures can be combined with high growth. In spite of inefficiencies at a micro-economic level, a country can and will improve per capita income if it generates high growth rates. Static, sub-optimal allocation can be offset by dynamic growth advantages (some economists use the term "dynamic allocation advantages"¹¹). For instance, if high growth occurs despite inefficient static allocation, technical progress will be enhanced due to capital accumulation.

Economic history is full of empirical evidence of this type of constellations:

During the "golden age" era of high growth in most OECD countries after World War II until the 1970s, financial markets, foreign exchange markets, interest rates etc. had been highly regulated in most countries. Although in most European economies labour markets as well as many goods markets were highly regulated, high growth occurred. Since the late 70s deregulation, liberalisation, privatisation, strong moves to more free trade etc. were promoted, but average growth rates diminished. Much of the advantage from better and more competitive allocation resulted in productivity gains which were not transmitted 1:1 into growth.

The East Asian newly industrialised countries enjoyed high growth periods for several decades until 1997 although they suffered in many cases from low allocational efficiency, bad institutions, corrupt political elites etc. One of the best examples for an extreme growth performance with low allocational efficiency is PR China since 1978. The brunt of investment was borne by rather inefficient state-owned enterprises. Financial institutions (state-owned), far away from competition, apply financial repression with considerable success. In spite of this there has been no substantial capital flight and saving in the home currency is extremely high in relation to income. It seems to be important that China combined high investment and a distorted micro-level with overall macroeconomic stability (Herr and Priewe 1999).

High growth in Japan until the 80s was accompanied by a high degree of protectionism, a comparatively low degree of internal competition, strong regulation of the financial sector and repressed interest rates. Some transition countries had embarked on shock strategies with radical liberalisation of markets, especially rapid privatisation, in many cases with disastrous growth performance. The Russian privatisation has led to dysfunctional private property which has caused an investment blockade.

The content of structural measures or the optimal allocation of productive resources is, according to "chapter 6", clearly described by liberalisation, competition, privatisation etc.

Certainly, in a general equilibrium model this will lead to welfare gains. But what is the reality in market economies? The basic idea is the implementation of perfect competition and pure private property rights. But perfect competition is worse than *workable* competition. It might instantly compete away pioneer profits and thus reduce profit incentives. Sometimes this can be healed by subsidies. Full price flexibility might increase information costs.

¹¹ We do not use this term since the meaning of allocation is bound to the optimal distribution of a given set of endowments. In a dynamic perspective endowments increase, e.g. by capital accumulation. Since we do not know the future endowments (especially capital, technical progress, but also labour force participation), it does not make much sense to speak about dynamic allocation over the time axis.

Are there not plenty of cases in favour of microeconomic market failure? Efficiency wages secure productivity incentives although they contradict the postulate of wage flexibility. There is nothing good in privatisation *per se*, e.g. private monopolies are not better than state-owned ones; in the majority of LDCs there is private property concerning land ownership but the type of distribution of property rights is often a severe barrier to agricultural growth and poverty reduction. The shaping of good institutions, including the structure of property rights, and the formation of efficient (not maximum) competition is a long process of trial and error. There is no universal blueprint for "structural measures".

Here modern *microeconomics* must be applied which can show that perfect competition does not always guarantee optimal results, that market failures of numerous kinds exist, that institutions matter etc. This insight is of tremendous importance for LDCs which normally are far removed from perfect competition.

3. Monetary and Exchange Rate Policies

3.1 The Causes of Inflation in Developing Countries

Inflation or deflation can be caused by cost factors and by demand factors.¹² Let us start with the analysis of *cost inflation*. According to the fundamental equations for the value of money the price level (P as an index) is determined by the nominal wages rate (w), productivity (π), the interest rate (i), capital intensity (Ψ , defined as K/N, with the capital stock K and employment N) and external influences (z) (see equation 3.1).

$$(3.1) \quad P = z \left[\frac{1}{\pi} (w + i\Psi) \right]$$

The term w/π represents unit wage costs, the term $i\Psi/\pi$ stands for capital unit costs. Nominal wages are the most important internal factor in explaining the cost structure. If nominal wages grow faster than productivity, unit labour costs and the price level will increase, other factors being constant. Higher prices lead to falling real wages and the likelihood again of increasing nominal wages. All major inflationary processes in developed countries are characterised by wage-price spirals. Capital intensity reflects the technology and wage costs and is of secondary importance in explaining inflation, since unit capital costs change little, apart from the influence of interest-rates fluctuations. High interest rates over a long period will be reflected in prices which have to cover interest costs. But inflationary processes are not caused by high interest rates.

For smaller countries in particular – and most poor countries are economically relatively small as measured by GDP – external cost factors are important.

If a country devalues her currency, import prices and the domestic cost level increase. An increase in the foreign price level has the same effect. If countries have to import manufactured goods and if the prices of these goods increase, there will also be an internal cost push. The stronger the devaluation and the higher the ratio of imports to national GDP, the stronger the impact on internal prices. As higher prices reduce real wages, it is very likely that a devaluation will trigger off a wage-price spiral.

In many cases nominal wages have to increase. Otherwise real wages could fall below subsistence levels for substantial parts of the population and/or political unrest might emerge. The higher the inflation, the higher the likelihood of further devaluation. In such a situation a country is caught in a devaluation-inflation spiral which is combined with a wage-price spiral.

Let us now analyse *demand inflation*. If aggregate demand is higher than aggregate supply and the real level of production does not expand sufficiently, the price level increases. Production cannot increase when there is full capacity utilisation. Such a situation rarely happens and there is nearly always the physical possibility of increasing production. In most cases production capacities, including human resources, are not fully used as entrepreneurs expect no or low profits or believe that the situation is too uncertain to produce more.

High demand can have different sources. First, investment demand may be very high. In such a case capacities will increase when investment projects mature. Thus high investment demand as a source of inflation tends not to create long-term inflationary problems. Private consumption demand and export demand can also create inflation. In these cases excess demand will not directly increase capacities. It depends on the specific historical constellation and on the expectations of the entrepreneurs whether the high demand stimulates investment or not.

In many developing countries fiscal policy is an important source of inflation. If budget deficits are financed by bank credits and bonds (bought by the public or by banks) – that means without money creation by the central bank – high government demand has the same effect as, for example, high consumption demand. If government demand stabilises capacity utilisation it can create a positive climate for private investment. If government demand is not met by higher investment it will, sooner or later, result in inflation.

In many LDCs budget deficits are financed by central bank credits.¹³ In this case there is an additional channel for inflation. The public will not hold more central bank money than it wishes. As long as the budget deficit does not increase faster than the demand for cash there will be no problem. If the budget deficit is too big, the public will try to get rid of the additional central bank money. Let us say the government constructs a road for 10 million local currency units, and this is financed by central bank credits. Let us also assume that the public holds central bank money equal to about 10 percent of GDP.

In this case – at a given price level – real GDP has to increase by 100 million in order for the private demand for central bank money to increase to the same extent that the budget deficit has increased the money supply. If in our case GDP increases by only 50 million, the public will wish to get rid of 5 million central bank money. The public can deposit the money at banks. In this case, banks may reduce their credits from the central bank, so central-bank money is destroyed.

¹² Here we follow a Keynesian inflation theory, see Keynes 1930, Riese 1986, Heine/ Herr 2000.

¹³ Central bank financing of budget deficits can be hidden if banks buy government bonds and the central bank buys the bonds from the banks.

If the budget deficit is too big and banks do not have enough credits from the central bank it is very likely that private agents will try to exchange their excess money for foreign currency. Of course, agents could also buy more local assets or additional domestic consumption goods, but this is not very probable. If the central bank has to defend a nominal exchange rate anchor, and there is already a pressure for devaluation, the central bank has to buy the money, and it will be destroyed again. If the central bank has no more reserves left, a devaluation will take place. This will push inflation via cost hikes. And this means that budget deficits financed by the central bank may create inflationary pressure via the exchange rate in spite of a lack of aggregate demand.

For developing countries the worst of all worlds is the combination of high budget deficits financed by the central bank, devaluation and a wage-price spiral. In this case there can be very high inflation rates in spite of a lack of aggregate demand. The country is stuck in stagflation. Macroeconomic policy has to plug the two most important sources of inflation: devaluation and the financing of the budget by central bank money.

It is frequently argued that the inflationary effect of budget deficits financed by central banks can be reduced by external financing.¹⁴ This is only the case under certain conditions. Under normal conditions, excessive external finance can create inflationary pressure as well as too high a budget deficit. There is no doubt that budget deficits financed by central bank credits can create inflationary pressure due to demand inflation and low supply elasticity. But if governments want to spend more money to buy domestic goods, to support their population with subsidies or to employ workers, external finance may also increase the money supply. Actually, in these cases the government does not need dollars, Euros or Yen, it needs more of its national currency. If the government asks the central bank for domestic currency, there is no difference to the case of asking for direct central bank credits as far as the possibility of inducing inflation is concerned. This can possibly be offset by restrictive monetary policy, but it does not make much sense to ask for foreign savings and at the same time to curtail the domestic money supply. The situation is different if the government sells its foreign currency on the foreign exchange market. In this case it buys local currency without increasing the money supply. But if everything remains unchanged, this will create an appreciation of the domestic currency and precipitate a current account deficit – the capital import causes the corresponding current account deficit (see equation 2.2) and reduces the demand for domestic products and thus GDP.

In all these cases the inflow of foreign savings has adverse, unintended effects, which show that normally a scarcity of domestic savings *cannot* be simply compensated for by capital inflows; this applies not only to the various forms of foreign capital, but also to grants.

3.2 Monetary Policy Needs Nominal Exchange-Rate- and Wage-Anchors

Monetary policy and exchange rate anchors

Relatively low inflation rates and a relatively stable nominal exchange rate are essential for macroeconomic stability. We agree with this argument in the sourcebook (World Bank 2000, p. 17f.). We also agree that countries should choose a *nominal anchor*, as “evidence shows that inflation performance has been better in countries using a nominal anchor.” (World Bank 2000, p. 19). A nominal anchor involves a nominal target as opposed to using a real variable as a target, as for example in the case of a real exchange rate. Indeed, *real* variables as targets are useless for monetary stability. A real exchange rate target, for example, can lead to a devaluation-inflation-spiral and a cumulative inflation. The authors of “chapter 6” recommend: “Using a nominal anchor involves specifying and committing to a predetermined path for a nominal variable – such as the exchange rate (...) or a money aggregate – that is to a certain degree under the control of the authorities.” (World Bank 2000, p. 19) A substitute for a nominal variable is a direct inflation target. Advantages and disadvantages of the different nominal anchors are discussed without a clear conclusion (World Bank 2000, p. 20f.).

The authors do not seem to be clear that following an exchange-rate target or an inflation target is something completely different from following a monetary strategy that aims at a certain growth rate of an aggregate money target. The latter – the monetary rule in the tradition of Milton Friedman – is at the core of the neoclassical quantity theory of money. The former – a discretionary monetary policy to stabilise a nominal variable – follows a Keynesian approach to economic policy.

In our opinion money aggregates are not appropriate as nominal targets. Most central banks in developed countries have abolished money targets because they did not work. First, central banks trying to realise a certain growth rate of a monetary aggregate were confronted with very unstable interest rates. Second, velocities of money aggregates – from M1 to M3 - became more and more unstable. Under such conditions a monetary rule makes no sense. Even the German Bundesbank, one of the last central banks trying to follow a monetary rule, had to accept that it could reach the money target only about fifty percent of the time. During the 90s more and more countries – for example the United Kingdom, Sweden, Australia – started to follow direct inflation targets (Bernanke and Mishkin 1997, BIS 2000, p. 74 ff.). Other countries followed only a monetary rule – for example the United States from 1979 until 1982. Since 1982 however especially under Alan Greenspan a wide range of indicators have been used to follow a discretionary monetary policy. Even the European Central Bank, heavily influenced by the Bundesbank tradition, stresses in its two-pillar strategy more the role of a set of indicators than the “reference value” of the growth of M3 (ECB 1999).

In developing countries, a monetary policy that aims to realise a certain growth rate of a money aggregate is bound to fail. It is very likely that in developing countries the velocity of money is very unstable and difficult to predict.

¹⁴ “In theory, if inflationary pressures from the fiscal stance are being transmitted exclusively through the financing channel, than inflationary pressure could be reduced without fiscal adjustment if alternative (sustainable) sources of financing, such as external financing, are available.” (IMF 2000, p. 19)

In developing countries a high proportion of monetary wealth is kept in relatively liquid form. The more liquid the monetary aggregate, the more unstable it is – this at least is the experience in developed countries. Developing countries are confronted with dollarisation - a large proportion of monetary wealth being kept in foreign currency. A change in the intensity of dollarisation will lead to big changes of the velocity of the home currency. This is an additional argument against a neoclassical monetary rule.

For nominal targeting there can only be a choice between an exchange rate anchor and a direct inflation target. Both of these targets have the advantage that money supply as measured in different money aggregates – M1, M2, and so on – does not matter and becomes endogenous. In this case it is also no problem for monetary policy if the velocity of money is very unstable.

In the case of LDCs there is a clear advantage to choose the nominal exchange rate as an anchor. A nominal exchange rate anchor is the best available way to stabilise the internal asset market and prevent or – in most cases – reduce dollarisation. A nominal anchor that can be defended successfully increases the credibility of the home currency, reduces uncertainty and gives room for central banks to reduce interest rates and improve the conditions for high investment and growth. As central banks in LDCs usually are not independent, an exchange-rate anchor is likely to have a higher credibility. For central banks it is sometimes an advantage tying one's hands – at least this was the experience of reducing inflation in inflation-prone countries during the eighties (Giavazzi and Pagano 1988).

A nominal exchange rate anchor is easier recommended than achieved. The problem is that a nominal exchange rate anchor will only stabilise expectations if it holds, and an exchange rate anchor only holds if everybody believes that the exchange rate will never be changed: "It follows that in a world of high capital mobility there are only two feasible approaches to exchange rate policy. One is not just to peg the exchange rate but to lock it in." (Eichengreen 1999, p.105) To successfully establish a nominal exchange-rate anchor certain conditions have to be met. The most important point is a low internal inflation rate. This can be reached by establishing an additional nominal anchor: a nominal wage anchor. If the nominal wage level increases with the same rate as productivity (see equation 3.1) a wage anchor is successfully implemented (see below).

As budget deficits financed by central bank credits are the second major channel for inflation in LDCs a sound fiscal policy is the second precondition for a nominal anchor.

International capital imports and capital exports can create problems for an exchange rate anchor. LDCs should therefore use certain capital controls to defend the exchange rate. This topic will be discussed in section 3.3.

It may be argued that a nominal exchange-rate anchor is very costly as it forces the central bank to follow a monetary policy to stabilise the exchange rate and not a policy based on internal needs. This argument is illusory.

Especially for countries with weak currencies, it is very difficult to follow a monetary policy that is completely oriented to internal factors. Even the United States had to undergo a stabilisation crisis to stabilise the dollar at the end of the seventies and beginning of the eighties. Countries with weak currencies are very rarely in a situation to reduce interest rates, devalue and increase exports and growth. There is always the danger that the devaluation gets out of control and triggers off a devaluation-inflation spiral. Or the impact of the negative effect of a devaluation on the reputation of the currency will lead to high interest rates. In these cases the costs of stabilising the economy are much higher than stabilising the nominal exchange rate.

In the sourcebook it is argued that under certain conditions a flexible exchange rate is the best solution and that “there is no universally ‘right answer’” (World Bank 2000, p. 21) which exchange rate regime is the best. We argue that a *nominal fixed exchange rate* is the best solution for a country if it can be combined with the absence of current account deficits. The worst solution are flexible exchange rates without central bank interventions. Frequently adjusted pegs and crawling pegs are second best solutions if more macro-economic stability is not possible.

Given the nominal exchange rate, international competitiveness can only be defended if the internal inflation rate is not higher than the international inflation rate. This means that the inflation rate in LDCs should not only be below ten percent; it would be a big advantage if the inflation rate were even lower as to defend the nominal exchange rate without losing international competitiveness. When speaking about inflation rates we focus only on the price level of tradable goods. Non-tradables can have a higher inflation rate in developing countries as their price increases do not reduce international competitiveness. Tradables are mainly industrial products and in poor developing countries to a large extent agricultural products. It is likely that productivity increases in developing countries in the production of tradables are hardly possible in the short run. With a given exchange rate, the competitiveness depends to a large extent in the short run on low wages and low wage increases mainly in agriculture. Our concern for low inflation relates to the comparison with inflation rates of anchor currencies. Under conditions of financial globalisation the inflation rate of hard currencies is the relevant benchmark if devaluations are to be avoided.

If a country cannot realise low inflation rates of tradable goods it will lose international competitiveness. In such a case the exchange rate has to be adjusted. Such a policy is not costless: if the exchange rate has to be adjusted frequently many of the advantages of the nominal exchange rate anchor are lost.

Because of conditions in LDCs it is very likely that nominal anchors will sometimes break down. If a nominal anchor leads to a current account deficit, a country should not wait too long to devalue her currency. In such a case a country has to steer an optimal course between the negative effect of an exchange rate adjustment and the build-up of foreign debt. As foreign debt should be avoided, in the event of a current account deficit, an *early* devaluation seems to be the best of two bad options.

It is important that, after the devaluation, the country immediately tries again to establish a nominal anchor as only a permanent fight for macroeconomic stability can create the macroeconomic conditions for investment and growth. An exchange-rate regime with an infrequently adjusted peg should not be confused with a flexible exchange-rate system.

A nominal crawling peg could be used as a kind of soft nominal anchor. But it should be clear that a crawling peg stabilises a certain inflation rate as permanent devaluation leads to permanent inflation. The crawling peg may be useful to move from high devaluation rates to low ones and finally to a stable exchange rate. In some cases it is better to jump from an unstable situation directly into a stable one. In this case a crawling peg is not useful.

Which currency should be used to peg? Of course it should be a stable one, for example the dollar, the Euro or the yen. The problem is that exchange rates between the leading world currencies are not stable (Herr 1996). To peg against the dollar was very dangerous for Asian countries before 1997, the year of the outbreak of the Asian crises, as the yen declined in value against the dollar and Asian countries had intensive trade relations with Japan. If a country is not indebted in foreign currency, it should peg against the main trading partner or a basket of the main trading partners. If the country has a significant foreign debt, it should peg against the currency of the most important creditor country, or a basket of currency based on the structure of the foreign debt. If the structure of trade is different from the structure of foreign debt it becomes difficult to choose an optimal peg. This is an additional argument to avoid foreign debt.

Developing countries and especially the LDCs are exposed to shocks that are more severe than in the case of developed countries. Such shocks can create pressure on the exchange rate and eventually destroy a nominal exchange-rate anchor. It would greatly add to macroeconomic stability of LDCs if the international community – maybe represented by the World Bank and the IMF – provided funds to help to stabilise the exchange rates. There are two cases where international help would be especially valuable. One concerns the case of a world market shock that affects LDCs, such as a drop in the price of their major export goods. The other concerns an internal shock, such as a drought or an earthquake. In these cases the countries are affected in spite of sound policies. As always, grants are better than credits. The help in these cases should be unconditional to avoid anti-democratic influences of creditor or donor countries on internal matters of LDCs. If the economic policy in the country is to blame for current account and exchange rate problems help should only be given for humanitarian purposes, and the country should be urged to improve macroeconomic stability.

Wage anchor and incomes policy

In "chapter 6" of the sourcebook several nominal anchors for price stability are discussed in detail, but one important anchor has been forgotten – the wage anchor. Wages become an anchor for the price level if the wage level increases with the same percentage as productivity increases. In equation 3.1 (in section 3.1) it becomes clear that wage increases in line with productivity increases leave unit labour costs unchanged.

In many countries unit labour costs are one of the most important factors in determining the price level, although in the case of small open economies devaluation is even more important.

The idea of *incomes policy* is to stabilise the price level by following a productivity oriented wage policy. As wages are the most important factor in determining the price level, a functioning incomes policy supports the central bank's fight against inflation. Monetary policy can be more expansive and can stimulate investment if it is not necessary to use high interest rates to reduce demand so as to stabilise the price level. A productivity oriented wage development also has the function of preventing deflation. Falling wages would lead to a deflationary wage-price spiral. Deflation – like a devaluation in case of foreign debts – increases the real debt burden and leads to the danger of a great depression. This aspect is also very important as central banks have only weak instruments to eliminate or even to prevent deflation.

It is not clear why in the sourcebook a wage anchor is not mentioned. To argue in favour of a nominal wage anchor implies that wages together with productivity are important for the determination of the price level and not directly for employment. This is the reason why Keynes (1936) argued for rigid nominal wages as a backbone for macroeconomic stability. Maybe the authors of the sourcebook believe that falling real wages increase employment. In this case a nominal wage anchor would be regarded as a problem not as a solution, similarly to simple neoclassical models in which such a wage policy prevents the real wage decreases which are seen as a precondition for higher employment.

In less developed countries – especially the smaller ones – to stabilise the price level the nominal exchange rate may be of more importance than the nominal wage anchor. Even if this is the case and monetary policy is oriented towards stabilising the nominal exchange rate, a nominal wage anchor is important for supporting the exchange rate anchor and monetary policy. A nominal exchange rate anchor will support a nominal wage anchor and vice versa.

A successful implementation of incomes policy needs certain institutions. The traditional way to implement incomes policy is to organise co-operation between unions and employers associations. In many LDCs, labour market institutions are underdeveloped or non existing. In such a situation there is the option of using a tax-based incomes policy. That means that the government heavily taxes wage increases that are not compatible with price level stability. In several transition countries in Central Europe this type of incomes policy was applied successfully.

Usually incomes policy is embedded within a co-operative political regime – a very important element for development. That is the reason why incomes policy in most cases involves co-operation between unions, employers associations and governments. The main purpose of incomes policy is to guarantee rigid nominal wages that increase in line with productivity and that create neither inflation nor deflation. The co-operation between government, unions and employers associations could address additional topics. For example poverty reduction, minimum wages, social security systems, taxation etc. could be themes of such "round tables".

The newly developed poverty reduction strategy of the World Bank and IMF includes the involvement of representatives of civil society in LDCs (IMF 2000, p. 114f.). Such an approach is very positive and can also be used for incomes policy especially where there are no developed labour market institutions for wage negotiations.

The establishment of stable domestic *financial markets* is one of the core problems of development. Macroeconomic policy has to be geared towards this aim. We disagree with the neoclassical vision that the optimal allocation of resources is the key for economic development. So-called structural adjustment programs are not a successful strategy for growth and development even if allocation would be improved. The breakdown of the “*Washington Consensus*” clearly shows that allocation is *not* the key for development. In the sourcebook the old idea of the “*Washington Consensus*” is still the somewhat hidden philosophy for development although some new and valuable concepts are added. For the design of economic policy it makes a big difference whether optimal allocation of resources is the first aim of economic policy (neoclassical approach) or the creation of stable financial markets in domestic currency (Keynesian approach). Stable financial markets of various kind (loans, stock and bond markets) firstly require certain financial institutions; secondly, they require relative price stability, the latter being based on currency stability and fixed exchange rates, nominal currency and wage anchors and to some extent capital controls.

There is no doubt that low inflation or price stability is necessary (although not sufficient) for sustained growth. Low domestic inflation based on a nominal wage anchor and a fixed nominal exchange rate describe a constellation that is likely to establish stable domestic financial markets, reduce capital flight and lower the extent of a parallel-currency systems. So the domestic currency becomes strengthened. In chapter 2.3 we argue that a current account deficit reduces domestic demand and that it is a doubtful idea that the foreign saving is necessary for development. The main purpose to prevent current account deficits is to stabilise the domestic financial markets as foreign debt is extremely dangerous for developing countries. Current account deficits – if not financed by foreign direct investment – increase debt dominated in foreign currency. In this case any devaluation will increase the domestic real-debt burden and will create liquidity and solvency problems of banks, enterprises or the state. The Latin American crises during the eighties led to the overdebtedness of governments as mainly governments went abroad to get foreign credit. The Asian crises in 1997 led to the overdebtedness of banks and enterprises as the private sector went abroad to get credits. If a country has a high foreign debt and has to devalue substantially the coherence of the domestic asset market breaks down as credit-chains are pulled apart. In such a situation the reputation of the domestic currency will be destroyed as well. Stock market crashes are hardly avoidable. Typically there will be an exchange rate crisis, a domestic financial crises and a stock market crises at the same time, and the three crises will stimulate each other. This will depress growth for long time. The absence of current account deficits is like a macroeconomic safety-net for developing countries to reduce the high danger to slip into a situation of long-term financial crisis and long-term stagnation.

To summarise: Low domestic inflation rates relative to hard currency countries, stable or even fixed exchange rates and the absence of current account deficits (or a surplus) give the ideal macroeconomic constellation for development as

domestic financial markets are stabilised by low inflation and stable exchange rate and

the absence of current account deficits (or even surpluses) create expectations of a stable exchange rate in the future and

additional demand for goods is created in the case of current account changes (lower deficits or higher surpluses).

Such a situation gives room for relatively low nominal and real interest rates. Under such conditions investment will most likely increase and stimulate a positive credit-investment-employment-income process. The optimal case would be a lasting period of real undervaluation of the domestic currency which for instance characterised the German and Japanese post-war high growth phase. For many developing countries the above constellation is not easy to realise. But the more a country can go *in the direction* of price-level stability, stable exchange-rates and current account equilibrium the more likely it is that the domestic financial market will unfold and domestic investment will increase.

3.4 The Case for Capital Controls

In "chapter 6" of the sourcebook questions about the structure of the balance of payment are not discussed. The authors do not make clear whether they think that LDCs should have current account surpluses or deficits, or which types of capital imports or capital exports are good or not for LDCs. They seem to leave it up to the markets. Furthermore, they seem to be convinced that there should be full convertibility of the currency and full liberalisation of capital markets, although such propositions are not explicitly made.

We believe that balance of payment sustainability and currency stability are crucial issues for macroeconomic stability, and that they have a strong influence, directly and indirectly, on poverty. In addition all strategies focussed on the use of foreign finance used for poverty reduction must address the questions of how to keep the current/capital account in balance, how to stabilise exchange rates and how to use exports as an essential source of demand. Here eminently important sources of instability can be generated – or prevented depending on the choice of institutional regime.

The authors of "chapter 6" discuss only the direct income effect of capital controls on the poor. They argue that capital controls can force the poor to hold their assets in domestic currency. This means that they suffer from devaluation much more than the rich who find ways to hold foreign assets. The poor may also suffer if domestic interest rates are low, and they are not allowed to keep foreign currency accounts (World Bank 2000, p. 22). The conclusion of the authors is: "If properly managed, financial liberalisation policies can therefore have the additional benefit of increasing self-insurance by the poor." (World Bank 2000, p. 22). This is a hidden invitation to an intensified *dollarisation* in LDCs which weakens the domestic currency and domestic monetary policy.

In our opinion capital controls have to be discussed in a completely different context. Can capital controls reduce the vulnerability of countries and increase the growth rate (with positive effects for the poor) – for example by reducing the likelihood of currency crises? The question of capital control is vital for the whole concept of macroeconomic policy. In this section we focus in particular on the problem of capital account convertibility. For questions concerning the current account see section 2.3.

Western Europe, North America and Latin America started to liberalise international capital movements in the late 1960s, East Asian countries and many other LDCs liberalised their capital movements substantially during the 1990s (Cooper 1999, p. 95ff.). Since the 1970s balance of payment and currency crises have been becoming more frequent and much deeper than before. The pattern of these crises have been more or less the same. There was a medium-term period of net capital imports into the countries and a fast built-up of foreign debt, generally in the form of bank credits or debt securities. Then something happened that changed investors' expectations. This could be an unsound macroeconomic policy, e.g. weak monetary discipline, a world market shock, political developments inside LDCs, contagion effects or changes in expectations that can hardly be explained by fundamentals. When the state of expectations worsened capital imports ceased or even turned into a net capital export. Then the affected country ran into a balance of payment crisis. In Latin America less than a decade of current account deficits during the 1970s ended in deep debt crises across the whole of the sub-continent in 1982. The Latin American debt crisis which erupted in 1982 first hit Mexico, and Mexico was then hit by a second deep crisis in 1994. In both cases there was a medium-term accumulation of current account deficits. Before the Asian crisis which started in 1997, capital controls had been abolished for only about five years. In the case of the crisis in Latin America, it was governments and near-government institutions that were the main debtors, while in the later Asian crisis, it was banks, investment funds and private enterprises that were the main debtors (Herr 2000).

The result of these crises was always the same. A swing from capital imports to capital exports led to a substantial devaluation. The latter increased the real-debt burden of debtors in LDCs and led to liquidity problems. But the liquidity problems only reflected the surface of the problem. Behind this there were severe problems of solvency. Debtors had become over-indebted, and were not in a position to pay back their debt in the future. For example, the devaluation of the Thai Bath by 30 % in 1997 may have created a situation in which a firm in Thailand with a high foreign debt suddenly had more debts than assets and would have to go bankrupt. Even governments or central banks may have such high debts in a foreign currency that they are not able to fulfil their future commitments. Short-term credits from the IMF and/or governments from developed countries relieve the distress but not cure the illness, as assistance with short-term liquidity cannot cure solvency problems. The IMF and similar institutions did not take over the function of international lender of last resort, as this function involves providing short-term liquidity for a debtor who is not over-indebted. Instead, they became managers of bankruptcy, which is a completely different task to helping debtors with short-term liquidity problems (Herr 2001). Balance of payment crises are accompanied by high interest rates to reduce capital flight and/or to stimulate capital imports and in order to defend exchange rates.

Restrictive monetary policy, which in such crises cannot be avoided, curbs investment and private expenditures in general. So-called stabilisation crises lead to low or in most cases negative growth rates in the medium term. They can push a country onto a lower long-term growth path, or even into long-term stagnation.

In the sourcebook it is argued that countries should not stick to fixed exchange rates when the exchange-rate regime leads to high current account deficits and it becomes clear that the exchange rate is not sustainable over a longer period (World Bank 2000, p. 20). We agree. But the conclusion is not that flexible exchange rates can solve the problems of unstable capital flows between the developed and less-developed world. If the Asian countries, which before 1997 had nominal pegs to the US Dollar, had abolished the fixed exchange-rate regime, for these countries there certainly would have been - prior to 1997 - a danger of appreciation and even of higher current account deficits. The result might have been an even deeper fall in the external value of their currencies. In 1996 and 1997 the Czech Republic had to encounter exactly the same experience. In spite of high current-account deficits, and the Czech central bank's aim of avoiding a strengthening of the currency, the more flexible currency regime which was implemented led to an appreciation and even higher current account deficit – until the crisis in spring 1997 (Frensch 1999).

Capital inflows can obviously be very dangerous for LDCs. It is highly questionable whether current account deficits really help to develop countries. Even if one believed that current account deficits are good for countries, there are no good arguments why liberalised capital markets enhance growth in LDCs. Certain types of capital inflows make LDCs very vulnerable. At the same time, it is not very likely that this type of capital inflow will increase productive investment:

”There are a number of reasons more generally why the view that capital account liberalisation gives rise to enhanced growth should be regarded with scepticism. Liberalisation has, in general, focused on opening a country to short-term speculative flows; but precisely because of the volatility of such flows, it is hard to base productive long-term investments on these funds.” (Stiglitz 1999, p. 1511)

Overall, the wave of capital liberalisation has not improved the performance of LDCs. Since the Asian crisis, more and more economists have been arguing that LDCs must be protected against destabilising capital flows, and that they should use capital controls to prevent unwanted capital imports.

Let us discuss the most important channels of capital imports:

a) *Short-term carry trade between banks*

There are short-term capital inflows from foreign banks to internal banks and other internal financial institutions. This so-called *carry trade* takes for example the following form: Domestic banks and other financial intermediaries borrow money from foreign interbank markets – issuing short-term paper – or simply obtain short-term credits from foreign banks or other financial institutions in developed countries.

The borrower exchanges the foreign money for local currency and extends a credit to internal borrowers, for example enterprises. The internal borrower has an incentive to take such foreign credits because the interest rate abroad is lower than in the home market. This happens quite often as LDCs usually have higher internal interest rates than developed countries. Of course, the cost of foreign-currency credits is only cheaper if internal borrowers expect a (relatively) stable exchange rate. If the devaluation rate during a given period is higher than the difference between the foreign and home interest rate for the same period, then the foreign currency credit becomes more costly. Such credits have a maturity of only a few months or even less. So agents tend to believe that the exchange rate will be stable, at least until the credit must be paid back – even if they believe that in the long run the exchange rate will not be stable. Foreign banks have an incentive to give such credits because the borrower in the LDC has to pay a higher interest rate than borrowers in developed countries. For the creditors, an exchange-rate risk does not exist as the credit is denominated in their currency. As long as foreign creditors believe a debtor remains liquid they need not worry about the exchange rate. In the case of carry trade they usually expect that over a few months nothing negative can happen and that the borrower will be able to pay back the credit. As long as expectations do not change, the credits are simply rolled over into the next short-term period (Eichengreen and Mathieson 1998).

b) Short-term credits between domestic enterprises and foreign banks

In LDCs such credits are only possible if they are denominated in foreign currency. From both the creditor and debtor side the motivation for this type of credit is more or less comparable with carry trade. The main reason for this type of credit is that credits in foreign currency seem to be cheaper than credits in the local currency. One additional motivation may be that the enterprise wants to buy foreign goods or services.

c) Portfolio investment in private debt-securities

In this case domestic enterprises or banks issue medium- to long-term debt securities denominated in foreign currency. The motivation is the same as discussed under a) and b).

d) Portfolio investment in stocks

Foreign investors buy stocks of domestic enterprises or banks amounting to less than 10 % of the equity of the firm. Portfolio investors are mainly short-term oriented, and are in many cases speculators. Investment of this type may stabilise domestic stock markets by leading to asset-inflation during inflows and falling stock-prices during outflows (cp. BIS 1998).

e) Foreign direct investment

In LDCs credit channels a) and b) should be restricted or even prohibited as these types of capital import are not useful for a country but dangerous. This is especially the case if the internal financial system in LDCs is not as developed as in developed countries, which is always the case.

We agree with Eichengreen:

"This creates an argument for limiting or taxing bank borrowing abroad as a third line of defence against banking-system instability in countries where the first and second lines of defence – banks' own risk-management and regulatory supervision, respectively – do not suffice. And where banks can circumvent these measures by corporations to do the borrowing and pass on the proceeds to them, broader measures may be required. Financial stability may have to be buttressed by a Chilean-style tax to limit short-term foreign borrowing by all domestic entities. (...) In practise, this means that they are necessary in most 'underdeveloped' countries." (Eichengreen 1999, p.12)¹⁵

Of course capital-import restrictions may increase the interest rate for domestic firms, especially the small and medium ones (Edwards 1999). However, this is not necessarily bad. First, a cheap foreign credit proves to be very costly after the exchange rate has collapsed and a firm has not hedged or used other ways to eliminate the exchange-rate risk. Second, sometimes it is useful if the central bank can increase the interest rate. In Thailand and the other countries involved in the Asian crisis, central banks increased interest rates to slow down the booming economy. The more the central banks increased domestic interest rates, the higher was the stimulus to obtain credits from abroad. So monetary policy was rendered toothless as there were no controls on capital-inflow. In other words: one of the advantages of capital controls is to make domestic monetary policy workable and prevent it becoming paralysed.

Capital import channels c) and d) can likewise create instabilities in LDCs and should also be restricted. Channel d) directly creates no risk of changing the real debt burden and is preferred to c). Indirectly, however, this channel can be harmful: sudden outflows (or a cessation of inflows) of portfolio investments can lead to devaluation and increase the real debt burden of other forms of indebtedness. As portfolio investment is short-term oriented and often speculative, it is not suitable for supporting development. This is especially the case when stock markets and bond markets are thin and can be influenced by a few, or in the extreme case, a single foreign investor.

Government credits – channel e) – should, if at all, be used with great care. The longer the maturity of the credit the better. Short-term foreign borrowing by the government should be avoided. The Russian exchange-rate crisis in 1998 has shown how dangerous it is for governments to have a large proportion of debt in foreign currency. In the first place, LDC governments should get grants to finance imports if necessary.

Foreign direct investment is the best channel for capital imports (see section 2.3). First, the time horizon of such investments is longer than for most other capital imports.

Second, the country does not have to bear the exchange rate risk if the capital flows back to the foreign country. Third, foreign direct investment offers the greatest likelihood of technology and managerial know-how transfer.

Capital controls can be an element in stimulating internal credit markets and asset markets in general. In LDCs the financial market can be characterised as an infant industry. If the price level is stable this market can grow faster if protected by capital controls. In this case the danger of dollarisation can be reduced.

Capital-export taxes can be useful. Especially during a period of crisis they can reduce capital flight and reduce the need to increase interest rates to stabilise the exchange rate. But it should be clear that capital-export controls can not be a substitute for a relatively stable internal price level. If the reputation of the home currency erodes, the incentive to circumvent capital-export controls becomes enormous.

A *Tobin tax* or similar transaction taxes are not sufficient to stop capital flows. A Tobin tax can only slow down very short-term speculative flows. But these are not the most important problems of LDCs. To control capital imports a Chilean style capital-inflow control would be one possibility. In this case capital imports have to be deposited without interest earnings for some months or even a year (for details see Eichengreen 1999, p. 519). The big advantage of capital-import controls is that they are easier to implement than capital-export controls. If capital is imported illegally the capital is inside the country and can – if it is detected – be confiscated. Thus illegal capital imports are risky. If capital is exported illegally it is outside the jurisdiction of the country and cannot be captured. Capital-import controls are more important because the main purpose of this type of control is in preventing crises. Capital-export controls are usually heavily used when there is already a crisis. In such a situation they can be helpful. The most recent example of this case was Malaysia after the crisis in 1997.

In LDCs capital-import controls should be of a long-term nature to prevent LDCs from becoming over-indebted in foreign currency and to increase the power of domestic monetary policy.

Capital-import controls have the important aim of supporting a market constellation of a balanced current account or, even better, current account surpluses. They can also be used to create a structure of capital imports - high foreign direct investment, no short-term credits, a limited quantity of long-term credits - which is not as risky as credits and which is more likely to promote development. Permanent capital-export controls can also be useful. Even if they do not work perfectly, they can increase the costs and risks of illegal capital exports sufficiently to keep wealth in the national currency. The precondition for this, of course, is a low domestic inflation rate and a nominal interest rate that is higher than the inflation rate.

The liberalisation of the balance of payment should be long-term oriented. Full liberalisation can be reached when successful development has led to catching-up with the developed world. Free current account convertibility should be the first step in the process of liberalisation. This does not preclude selective protectionism to shelter infant industries. If liberalisation is embarked upon, capital-export controls should be lifted first and capital-import controls should only be removed as the final step.

¹⁵ For similar arguments cp. Cooper 1999, Ito, Portes 1998 and Stiglitz 1999. Even Edwards (1999, p. 83) who is strictly opposed to capital controls has to admit that capital-import controls may work as a partial stopgap. Bhagwati (2000) argues that pro-free-

This line of thought is to a large extent accepted by the IMF:

„For many low- and some middle-income countries, therefore, full liberalisation of their capital account may need to wait until these countries are better able to manage external risks. This includes the ability to pursue monetary and exchange rate policies that are consistent with a liberalised environment. When liberalisation does occur, measures need to be carefully sequenced.“ (IMF 2000, p. 113)

It is strange that in „chapter 6“ of the sourcebook this IMF position is not even discussed.

Capital controls have been employed successfully in industrialised countries - one example is the „Wirtschaftswunder“ in Europe after World War II, and many successful LDCs have also combined rapid development with capital controls. China, for example, has combined rapid development with tough controls of capital imports and exports. The same situation existed in the so-called NICs before the wave of liberalisation in the 90s.

Undoubtedly, there exists an *“impossible trinity”* between three objectives: 1. stable exchange rates, 2. autonomy of monetary policy, 3. full capital convertibility including the liberalisation of financial markets. It is impossible to realise all three objectives simultaneously (Frenkel, Menkhoff 2000, p. 11 ff.). So one must consider priorities. Stable exchange rates for LDCs are of paramount importance since they are the precondition for macroeconomic stability; their economic function is similar to price stability.

Stable exchange rates are, on the one hand, a necessary, although not sufficient, condition for price stability; on the other hand, they ensure the stability of international credit relations. In addition, they can prevent a certain type of macro shock. If monetary policy in LDCs were autonomous and could be made suitable to the specific monetary problems of the respective country, it would be extremely helpful. As mentioned, for LDCs the macro impact of liberalised international capital markets is double-edged or even detrimental. Weighing up priorities, the result is unambiguously clear: the first two objectives incorporate a much heavier weight than the third. Furthermore, if capital convertibility as well as financial cross-border mobility is restricted, the first two targets are much easier to realise. Overall, there is a big net gain from macroeconomic stability at the expense of rather limited microeconomic advantages which are not essential for development, and which in many cases might even be extremely harmful.

4. Fiscal Policy and Poverty Reduction

Although fiscal policy is essential for poverty reduction there is no discernible systematic outline in “chapter 6”, either for the application of a fiscal policy that does not have adverse effects on the poor, or on the issue of how to finance poverty reduction measures. There are many valuable statements concerning appropriate fiscal policy but they are fragmentary. All in all, the fiscal issues are not addressed properly in “chapter 6”.

trade arguments do not likewise apply to free capital mobility: “Free Trade, Yes; Free Capital Flows, Maybe” (p. 21 ff.).

We first comment on these matters page by page, then we approach the key issues as we see them, and we end with some proposals.

4.1 Some Critical Comments on the „Sourcebook“

Tight fiscal policy stance in case of external shocks?

One of the basic guidelines of the paper is to distinguish between adjustments and accommodation in response to negative external shocks (World Bank 2000, p. 9). The former become necessary if some circumstances have changed permanently, the latter in the case of temporary changes. If adjustments are necessary, mainly due to a permanent shock to the balance of payments, the authors plead in the IMF tradition for a tight fiscal stance and a restrictive monetary policy:

“as this is the most immediate and effective way to increase domestic savings and reduce domestic demand – two objectives typically at the centre of stabilisation programs.” (World Bank 2000, p.10)

In many cases this has had disastrous effects on the poor and the overall economy. In the case of a severe stabilisation crisis it is unrealistic to believe that the poor can somehow escape austerity. The new idea in the IMF/World Bank concept seems to be to call for more external assistance to ameliorate the hardships.

Following this old and new IMF strategy in balance of payment crises, a *de facto* growth-reducing policy¹⁶ would be pursued, which hurts the poor if growth and poverty correlate. The hope for just a short-run limitation of growth may be fallacious because a devaluation-inflation-output-reduction-spiral is likely to emerge. Even in the event that the gap in the current account can be closed, this equilibrium does not *per se* generate growth (see section 2.1) either in the short or in the long run. It cannot be called “effective” to reduce GDP (and employment) in order to keep the balance of payment in order since the opportunity costs are very high¹⁷. The hope for higher long-run growth despite short-run shortfalls stems from the alleged growth enhancing consequences of improved allocation – which, however, does not exist (see section 2.4).

¹⁶ By definition the following equation is valid: $S = I + G - T - CA_{def}$ (saving equals investment plus budget deficit minus current account deficit). When the current account deteriorates it seems that the budget deficit must be lowered in order to keep investment unchanged. But the sequence of events runs differently: an increasing current account deficit will normally put pressure on the GDP which diminishes S.

¹⁷ A typical example of this constellation can be seen at present (February 2001) in Turkey: An uncontrolled domestically grown inflation has led to a situation where the nominal exchange rate anchor of the Turkish *Lira* against US-\$ and Euro could not be defended any longer under the condition of current account deficits. Capital controls do not help to prevent a crisis in such a situation as they cannot stimulate capital imports. The problem was that the current account deficit had not been avoided prior to the crisis. Subsequently the bust of the anchor could not be avoided, a 30 per cent devaluation of the Lira took place within one day leading to an inflationary push, to a strong increase of the real foreign debt burden. The IMF promised concessional loans tied to tight monetary and fiscal policies, further structural measures like privatisation etc. Capital-export controls could possibly reduce the pressure on the exchange rate. But they have not even been under consideration probably because there are fears of capital market distortions. However, the latter must be compared to the consequences of exchange rate distortions generated by an uncontrolled devaluation causing severe overreactions and volatility. The tight macro policies demanded have strong pro-cyclical effects. All this is the typical sequence of events causing low growth and higher poverty.

One of the problems with IMF stabilisation programmes is that the same standard fiscal policy is “recommended” to *all* countries - in most cases more or less *forced* upon countries as a condition of a loan - irrespective of the *market constellation* of the specific country. For example, the Asian countries after 1997 were forced to follow the same standard restrictive monetary policy as was required of Latin American countries during the 80s in spite of completely different situations. Different market constellations have to be addressed with different policies:

a) In the case of inflation caused by domestic factors - especially budget deficits financed by central-bank credits - and which leads to a currency crisis, tight monetary and fiscal policies probably cannot be avoided, and there is little chance of avoiding the costs of stabilisation and disinflation. The crucial point is that such an inflation must be prevented in advance. But even if this has been accomplished, there is some scope for discretion in deciding how restrictive fiscal policy should be and whether supplementary instruments, like capital-export controls, should be employed. But the macroeconomic problem of case a) must not be mixed up with current account deficits following currency crises caused by other factors.

b) There are two other causes of a balance of payment crisis: negative shocks in the terms of trade or sudden outflows or a ceasing of inflows of capital, for example as a result of contagion.

Capital outflows can to some extent be kept under control if capital-export controls are introduced and enforced (see section 3.5). It is more difficult to handle a cessation of capital inflows, especially if they are needed to pay back a foreign debt. Such current account crises may be a temporary problem, but nobody knows how long “temporary” is. Restrictive fiscal and monetary policy to reduce aggregate income to an extent that a current account deficit is lowered substantially is dysfunctional as it reduces domestic growth. So the alternatives to tight monetary and fiscal policies must be considered: (i) import restrictions by quotas or tariffs/taxes, (ii) further external borrowing, (iii) devaluation. The latter will trigger an inflationary push, impact exports in a double-edged way due to the higher cost of the import content of exports (which is considerable in small open economies), and it can induce a second wave of devaluation. Such a devaluation-inflation spiral can only be stopped if nominal wages are kept stable. If the current-account deficit is financed by additional loans, foreign indebtedness increases, which tends to weaken the currency and cannot be sustained for long. The salient point is to prevent such a crisis in advance since all three alternative options are full of problems. The decision on what measures should be taken ought to be based on considerations concerning GDP growth and poverty, not on the degree of putative price distortions.

Budget deficits

We agree that there should be no pre-determined fixed target level or upper limit for budget deficits (World Bank, 2000, p. 12). Indeed, case-by-case evaluations appropriate to the specific macroeconomic conditions are favourable. Public spending is justified, according to the authors, by market failures (e.g. public goods) or by redistribution. Fiscal stabilisation requirements are neglected (World Bank 2000, p. 14). In our view, short-run output fluctuations, business cycles etc., which lead to tax-revenue fluctuations, should be smoothed by deficits or surpluses, thus ensuring an anti-cyclical fiscal policy.

However, such a policy is approved by the authors of the sourcebook only for the case of positive shocks. According to traditional criteria which we appreciate, public investments can be financed by budget deficits. Active fiscal stimulation by public investment expenditures can help to overcome recessions and stagnation. Of course, fiscal sustainability criteria should not be exceeded, at least in the long-run. In general, we cannot see a clear fiscal policy guideline in “chapter 6”.

Social security net

The sourcebook calls for the formation of a social-security net (World Bank 2000, p. 9, 22f.). Limited and targeted food subsidies are mentioned, as are public works, transfers for income losses, social funds, fee waivers, scholarships for essential services such as education and health (World Bank, p. 21 f.). It is also argued that temporary support should be provided for those who are hit by shocks or austerity. We would add that the poor need basic schooling, health service, sanitation facilities, irrespective of any shocks or macroeconomic crises. Although the shape of these nets remains rather obscure, there is no question that one of the crucial points of any poverty reduction strategy is addressed here.

Whatever the architecture of a social safety net may be, there should be no doubt that some parts of this net are *public goods* which must be financed (maybe partially) out of the budget and by fees (or social security contributions).

Some parts of these outlays will be investments, like school houses, hospitals, wells etc. The key baseline of all this is that the public budget must be increased, since it is certainly unrealistic to finance these projects solely by reallocation within the given budget. So increases in taxes (or fees, social contributions etc.) are inevitable since most of these tasks are permanent, and only a part of them - namely investments - can (or should) be financed by credit, i.e. budget deficits.

It is not at all clear in the sourcebook by what criteria and to what extent external donors’ money (grants and concessional loans) should be used. Such funds seem to be considered as stop-gap means of covering budget deficits which austerity policy have left. Nowhere in “chapter 6” do we find economic criteria for why and for what purpose and to what extent external sources are to be poured into the financial institutions of LDCs. After all, the right questions are raised. Further below we sketch the contours of the answers.

Priority for private-sector development?

The sourcebook emphasises private-sector development (see, for example, World Bank 2000, chart 1 and p. 16) as the engine of growth. In principal, we agree, but at a more concrete level of decision making things are different. In many LDCs there is a weak private-enterprise sector, but for several reasons, at least in some countries, there is a rather strong sector of state-owned enterprises (SOEs). In the short run, privatisation is not possible, at least normally. Furthermore, in most cases privatisation will lead to employment reduction. In many cases, there is scope for the improvement of SOEs which is not implemented. Privatisation and poverty reduction should not be linked because there is no sound theoretical foundation for such a link.

On the other hand, if the social infrastructure for poverty reduction is to be established, e.g. the construction of schools, hospitals, houses, water facilities etc., local small and medium enterprises can be involved, irrespective of their ownership.

Public-works programmes can be implemented in private *or* public organisations. A principal bias against public organisations is not much better than the opposite.

“Chapter 6” derives the *priority of private investments, inter alia*, from the fear that public sector borrowing crowds-out private investment. With a finite amount of credit available, credit should be channelled to the more productive uses, that is to private-sector development (World Bank 2000, p. 16 f.). This argument follows a simple (and false) causal concept of a saving-investment-relationship:

- It implies that a higher credit demand will either increase interest rates (thus crowding-out private investments) and/or increase inflation (and also crowd-out private activity).
 - The case of demand inflation only occurs at high rates of utilisation of resources, let us say in a boom period – indeed, here additional credit and demand for goods will increase the price level. Of course, this is not a general, but a very special case.
- Neither public nor private credit demand always increases interest rates. As mentioned in section 2.2, credit demand and credit supply are stock variables and depend only to a small extent on current savings. If there is no inflationary danger, the central bank can finance the domestic banking system and allow a credit expansion without inflation.
- Finally, additional private as well as public credit demand for investments in a situation of unused capacity increases GDP, aggregate income and the flow of aggregate saving. Additional public expenditures also increases aggregate output and thus creates saving.
- Making the assumption that the supply of credit is finite *always* leads to giving priority to a permanently balanced budget. This is inconsistent with the propositions in other parts of “chapter 6” which stress the need for a flexible fiscal policy including budget deficits.

The authors of „chapter 6“ of the sourcebook admit that public borrowing used for infrastructure can *crowd-in* private investment. Therefore, they call for a priority assessment comparing private and public projects. In our view, this will be asking too much of policy makers. Instead, they should take care of public goods, and if these require public investments they may finance them with credit – as long as there is no inflation risk and debt-service is secured. This is the traditional Keynesian concept of fiscal policy: a balanced budget for current expenditures, whereas credit can be employed to finance the capital budget. We would add, *if* it can be done without inflation risks.

The sourcebook stipulates that the reallocation of public spending away from *non-productive* spending “including areas where a rationale for public interventions does not exist” (World Bank 2000, p. 15). But who is to decide what is unproductive?

Everybody knows that there is no uniform opinion amongst economists about this. So our traditional answer is that this issue should be left to democratic and/or civil-society-institutions (if there are any).

In general, the new IMF/World-Bank approach to poverty reduction tries to organise co-operation between donors, governments and civil society. We think that this could be a feasible approach to deciding about the structure of public expenditures and revenues.

Taxation

We agree with many of the statements concerning taxation (World Bank 2000, p. 14 ff.). There should be a broad tax base, but preferably low tax rates. The system should concentrate on a few basic taxes. Distributional effects should mainly be achieved by channelling expenditures towards the poor. More emphasis must be given to the institutional system of tax raising and its professional implementation. We will focus on three points:

- The tax system should privilege *retained profits* of companies against distributed profits. Although this might not be efficient in highly-developed market economies, under conditions of underdeveloped capital markets and strong inclinations to consume rather than to invest income it can make sense.
- Contrary to the paper we are in favour of *selective import tariffs* (or taxes) if targeted properly. Firstly, the traditional Friedrich-List argument in favour of protecting infant industries for a certain period is, despite all noisy appraisals of free trade, valid and has been practised by all the present industrialised countries including the successful Newly Industrialised Countries (Wade 1990, p. 113 ff.). The existence of positive external effects and of economies of scale provide two additional arguments in favour of tariffs (and similar instruments) on the basis of the neoclassical trade model. Secondly, the trade balance can be improved if imports of non-basic consumption goods are made dearer; this offers structural advantages (an incentive to invest, an incentive to buy domestic products, lower opportunity costs since otherwise the value of the currency would be lower) as well as additional budget revenues¹⁸. Finally, tariffs may stimulate FDI as imports are restricted.

Again, we lack a clear statement that poverty reduction requires *higher tax revenues*, and more than would follow simply as a consequence of higher growth. Parallel to poverty reduction through growth, *fiscal redistribution* is urgently required. Therefore, a broader tax base and higher tax rates are hard to avoid, if the combating poverty is seen to include the provision of public-goods-services for the poor¹⁹. We agree that taxation does not tend to be sensitive to aggregate investment (World Bank 2000, p. 15), so there should not be a trade-off between taxation and growth enhancing policies.

4.2 Do We Need External Funds for Poverty Reduction?

The key unanswered issue in “chapter 6” concerns the impact and magnitude of foreign funds earmarked for poverty reduction, and the inter-linkages with domestic monetary and fiscal policies.

¹⁸ With these arguments we follow a theory of pro-LDC trade aiming at trade surpluses with some degree of selective protectionism, but focussed on full liberalisation of imports in developed countries.

¹⁹ These services partially might be financed by fees, but certainly not (or to a very low degree) by the poor.

Potential financial sources for poverty reduction are mentioned (World Bank 2000, p. 11): tax and non-tax revenues, domestic borrowing, external finance (namely external borrowing), debt-relief, or grants.

As mentioned above, the sourcebook gives the impression that it regards foreign funds filling a gap without considering the macroeconomic implications of such foreign funds. However, at least in a short paragraph there is a reference to “*absorptive capacity constraints*”

“which could place upward pressure on domestic wages and prices, as well as appreciate the exchange rate and render the country’s exports less competitive, thereby threatening both the stability and growth objectives. The extent of such pressures will depend on how much of the additional aid is spent on imports versus nontraded goods and services.” (p. 17)

In addition, uncertainty concerning the stability of aid flows is rightly mentioned as well as the danger of long-term dependency on external official aid.

If these concerns are taken seriously there might be some important macroeconomic limits to the whole external-aid led poverty reduction strategy. Such an external based assistance may be feasible only to a very limited extent. We will try to explore this critical issue in the last part of this section.

If the amount of foreign finance inflows is quite small relative to GDP, there is no reason to consider macroeconomic effects. But under such circumstances foreign aid will not have much impact on poverty if the latter is large. So we must focus on inflows of foreign finance with significant macroeconomic effects. In very poor countries, such as those with 40 % or more of the population living below the poverty line, substantial poverty reduction undoubtedly has a macroeconomic impact.

What is the economic rationale for an additional inflow of foreign funds (in hard currency) into the LDCs? In principal, there are three alternatives:

(i) Foreign funds can be used for *additional imports*. The trade balance²⁰ (Ex-Im) is affected negatively. The additional imports can increase consumption, investment or government expenditures leaving GDP unchanged, although more can be distributed. Imports can, however, crowd-out domestic production if imported goods substitute internally produced goods. In this case GDP will be reduced. Only if the additional imports are used for additional investment might potential GDP rise in later periods after the investment has matured (in case this additional production is expected to be profitable which includes positive demand expectations). So only under certain circumstances will GDP rise, and it could also shrink as a consequence of further imports. The key question is whether more imported goods or services are really necessary or helpful for poverty reduction. In the case of grants both the inflow of money and the outflow of money for imported goods are booked in the current account.

²⁰ To make the argument easy we assume – if not mentioned otherwise - that the trade balance is identical with the balance of current account.

When foreign inflows come from loans (irrespective of the conditions) and there was, prior to the inflow, a balanced current account, the inflows now create, *ceteris paribus*, a deficit in the current account.

Credits have to be paid back later thus calling for reverse effects on the balance of payment in the future. If the domestic currency is devalued in the future, the real burden of the foreign debt will increase, even if no interest has to be paid.

(ii) The additional foreign finance can be spent on *servicing the foreign debt*, bringing relief. In this case the debt-burden of the government, if it is the debtor, decreases. *Ceteris paribus*, the current account will improve as the government does not have to pay interest to foreign creditors any longer. If the government spends the interest payments that have been saved on domestic goods, domestic demand will increase. In this case there is a stimulus for a higher GDP. Therefore, it makes sense to launch debt-relief programmes for LDCs. If the money governments in LDCs save is spent for the poor, debt relief and poverty reduction can be combined. If the debt service prior to the capital inflow had not been paid, and can now, foreign funds flows in and out at the same time, and in the same amount, everything else being unchanged. In this case there is no expansive domestic stimulus. The only result is that foreign creditors get their money back²¹.

(iii) Foreign grants or loans can be extended to the government or directly to domestic firms and institutions (e.g. NGOs). If the additional finance is not used for imports (case i) it will be changed into domestic money. Let us assume that the government, or other institutions receiving the foreign funds, ask the central bank to exchange the funds into domestic money. This will cause the domestic money supply to increase. However, foreign funds are not necessary in order to increase the domestic money supply. We can also assume that the foreign funds are exchanged directly in the foreign-exchange market for domestic money; this would cause the currency to appreciate, thereby crowding-out exports, and in such a situation the central bank would have to intervene to prevent an appreciation. This certainly has unwanted macroeconomic effects.

If the domestic money supply is increased due to inflows of foreign finance, this will lead to inflation if conditions for demand inflation are given or, more importantly, if the money supply increases to such an extent that the private sector is not prepared to hold the additional money. In this case foreign currencies will be demanded thereby inducing pressure on the exchange rate, and/or a flight into other assets, such as securities, gold or real estate, will be triggered (see section 3.1). On the other hand, the central bank might try to sterilise the influx of foreign money by reducing other channels of money creation. Sterilisation policy is possible in principle but in practice it is quantitatively limited. It is only in the case of a successful sterilisation that the inflow of foreign capital does not affect the money supply.

²¹ Note the monetary effects of servicing foreign debt: The transfer of domestic currency in hard currency and the subsequent outflow in the balance of payments lowers the aggregate money supply in the same way as foreign currency inflows, changed into domestic currency, increase the money supply.

However, for financing expenditure on domestic products and services by the government, enterprises or NGOs, foreign funds are not of much help. Increasing the domestic money supply would also have been possible using other instruments that may be used at the discretion of the central bank, but there is no need to choose the detour via foreign finance. Financing domestic expenditures via foreign funds can even be dangerous as it can create problems for monetary policy. It can lead to inflation and pressure on the exchange rate. The only positive effect is that foreign exchange reserves increase.

4.3 Guidelines for Foreign Aid to Reduce Poverty

Let us review these three alternatives. In the first case, it seems that an influx of foreign funds, if additional imports were needed, either directly for the poverty reduction strategy (e.g. pumps for wells which cannot be produced in the country), or indirectly for general investment goods which are necessary for growth-enhancing development. However, imports should be limited mainly to investment goods (in a broad sense) where there is no competitive domestic supply: consumer goods do not exert a lasting impact, if once-and-for-all-effects are to be prevented they would have to be imported permanently requiring a permanent inflow of foreign funds. An exception is funds to buy foreign goods after natural catastrophes such as earthquakes etc. In some instances products such as drugs or energy need to be imported for a longer period and these have to be financed by special inflows of foreign money.

In general, *grants* are much more favourable to development than *loans* because of the long-term burden of loans for the balance of payments. The balance of payments is negatively influenced by loans; if used to finance imports, the current account balance will initially be negative, whereas during the pay-back period the trade balance must turn positive. This exerts incessant pressure on the exchange rate with a permanent threat of increasing the real debt burden (even if interest rates are very low²²). If the loans are exchanged for domestic currency, the latter will appreciate; subsequently it will depreciate. The advantage of grants is that the balance of payments and the exchange rate will be less distorted, and the burden of real-debt redemption and interest payment will be avoided. However, grants also tend to crowd-out domestic production and distort exchange rates which tend to be higher than without grants. Furthermore, they stabilise economic and political dependence and. Correspondingly, passive attitudes, which are contrary to what is required to achieve more self-reliance.

To answer the question of whether imports are needed for a poverty-reduction strategy, the “Poverty Reduction and Growth Facility” (PRGF) as well as the “Medium-Term Expenditure Frameworks” (MTEF) must contain information about the amount of unavoidable imports, subdivided into investment goods, temporary services, intermediate goods and consumer goods. It is self-evident that poverty reduction measures should concentrate on domestic production and develop clear criteria for the use of foreign exchange. Otherwise adverse side-effects can occur leading to a crowding-out of domestic production and/or inflationary tendencies, and a stabilising of dependency structures and the corresponding attitudes.

²² Low interest rates of concessional loans have a tantalizing appeal to many LDCs. However, there is a wide-spread *exchange rate illusion*. Devaluations increase the real debt burden of foreign currency debt analogous to the so-called *Fisher-effect* in case of deflation.

Debt relief is helpful if the current account and the budget are alleviated. In many severely indebted LDCs, debt service absorbs a considerable proportion of GDP, of government expenditure and of export revenues, thus often turning the current account negative. When debt is still being serviced debt relief will strongly support macroeconomic policy targets. In this case debt relief creates some fiscal scope for manoeuvre which can be used to increase expenditures for poverty-reduction programmes. Here debt relief should be linked to such programmes. However, such measures do not call for additional net inflows of foreign finance. Instead, important outflows of domestic finance (changed into foreign currency) will cease.

The other alternative uses of inflows of foreign finance are not helpful for poverty reduction. Foreign currency will only be exchanged for domestic currency, with negative effects on the money supply and/or current account (except in case of successful sterilisation). In many cases, uncoordinated enlargement and reduction of foreign funds thus destabilise macroeconomic policies. Zero-sum-games can emerge, when foreign-exchange inflows are offset by reduced regular budget expenditures, by a decline in exports due to a currency appreciation, or by a tightening of monetary policy in the event that inflation accelerates because of an increase in the money supply. If inflation has been domestically generated as a result of too high budget deficits, it is illusory to think that using foreign funds will make it possible to avoid a stabilisation crisis. Such funds will aggravate inflation unless they are used for imports.

Of course, there may be some extremely poor countries that are not able to produce the increase in GDP necessary to fill the poverty gap (see the equations in section 1). Preventing mass poverty under these extreme circumstances requires massive additional imports, for investment goods as well as for other goods. There is no alternative but to provide them as grants and humanitarian aid. However, this would be the end of any development and growth, if practised for longer periods. New permanent transfer economies would emerge. We do not believe that is the normal and permanent case for LDCs or HIPC.

On the other hand, such types of help can be used in *temporary* emergency situations in the case of natural catastrophes or severe economic shocks induced by negative terms of trade effects, interest rate hikes caused by leading external central banks, world recessions etc. In these cases massive foreign aid, over a finite time horizon, in the form of grants used for additional imports may be appropriate. But such programmes do not stimulate development; they may, however, prevent the collapse of the economies.

But the bulk of normal poverty in LDCs probably is not of this type, it exists irrespective of such shocks. To combat this type of poverty, substantial additional *domestic* production of food, houses, infrastructure etc. is necessary and feasible, without (or with little) foreign finance. This additional production must be financed primarily by taxes, fees, and domestic credit as far as investments are concerned.

First and foremost, income generation by the poor, i.e. pro-poor growth, is the best of all alternatives, especially if exports can be raised. To open the markets in the developed world for products from less-developed countries improves the condition for development without any negative effects for less-developed countries.

The basic points of our reasoning are as follows:

- Poverty reduction requires *inter alias* additional public goods for the poor which will consist predominantly of domestic products. They must be financed by taxes, fees, and domestic credit in the case of investments.
- Foreign funds, no matter whether in the form of loans or grants, are only needed for additional import goods, mainly investment goods, that are not producible in the LDC, and for the relief of foreign indebtedness if domestic finance can be reallocated for poverty reduction.
- Inflows of foreign funds for poverty reduction must be co-ordinated and made compatible with monetary, exchange rate and fiscal policy. High inflows can have severe detrimental and unintended effects on macroeconomic conditions. Foreign funds should not supplant shortfalls in the domestic money supply or tax revenues. They can cause more problems than they seem at first glance to solve.
- In the event of economic shocks and natural catastrophes, temporary foreign aid can be helpful in preventing additional mass hardship.
- Grants are preferable to concessional loans.

4.4 Some Empirical Evidence on Foreign Aid for Poor Countries – Two Country Groups

Let us now look at the size of the poverty problem in LDCs in relation to the foreign aid that is actually paid to poor countries; in a second step we focus on those poor countries with the highest development aid ratio to GNP. Using the international poverty line of 1 US dollar per person per day, as the World Bank does, there are 1.2 billion poor in the Third World (World Bank 2000a). Of these, 77% live in the following 10 large countries with more than 60 Million inhabitants²³ (see table 4.1).

Table 4.1: Where the majority of the poor live – structure by countries

Country	population in millions	absolute poor in millions	poor/population in %	GNP per capital in US \$	income group
India	997.5	441	44.2 (1997)	450	Low
China	1,249.7	231	18.5 (1998)	780	Lower middle
Nigeria	123.9	87	70.2 (1997)	310	Low
Pakistan	134.8	42	31.0 (1996)	470	Low
Bangladesh	127.7	37	29.1 (1996)	370	Low
Indonesia	207.0	31	15.2 (1999)	580	Low
Ethiopia	62.8	20	31.1 (1995)	100	Low
Mexico	97.4	17	17.9 (1995)	4,400	Upper middle
Brazil	168.1	9	5.1 (1997)	4,420	Upper middle
Russian Federation	147	10	7.1 (1998)	2,270	Lower middle
Total	3,315.9	923	28.3		

Source: World Bank 2000a, own calculations

²³ For some countries poverty data are not available.

The majority of these countries are low income countries according to the World Bank classification, with a threshold of US \$ 755 per capita, some are upper middle income countries (US \$ 2,996-9,265)²⁴. It is easy to see at a glance that it would be asking too much from foreign aid to alleviate world-wide poverty substantially. It seems clear that even in case of very substantial increases in official development aid, the bulk of pro-poor measures must be financed by the countries themselves, and in principle, in countries like India, China, or Nigeria there should be no invincible economic hurdles to achieving this, in the absence of political barriers.

If we look at countries with the highest inflow of official development assistance as a per cent of GNP (see table 4.2), we find 21 countries with a ratio higher than 10% - all of them being small, low-income countries mainly in Sub-Saharan Africa. The threshold of 10% is chosen arbitrarily. It is not so much this threshold but the negative tendency which had led to more and more debt and transfer dependency. Nearly 200 million people live in this country group and, in the case of many of the countries, more than 50% of the population live below the poverty line, although data are not available for all these countries. If the average in this country group were 50%, not more than 8% of the world's poor live here. Note: not all African countries belong to this country group. Sub-Sahara Africa accounts for 24% of total poverty. The 21 countries are only a portion of the 64 low income countries classified by World Bank (World Bank 2000a, p. 334 f.).

Table 4.2: Countries with high official development assistance (ODA) in % of GNP 1998

Country	ODA/GNP in %	Trade balance/GDP in %	Poor ^a /population in %	GNP per capita in US \$ 1999	external debt/GNP in %	population in million 1999
Mozambique	28.2	-24	37.9 (1996)	230	74	17
Nicaragua	28.1	-36	n.a.	430	262	5
Malawi	24.4	-8	n.a.	190	77	11
Mongolia	20.6	-6	13.9 (1995)	350	49	3
Eritrea	19.7	-65	n.a.	200	11	4
Mauritania	17.8	-10	3.8 (1995)	380	148	3
Rwanda	17.3	-16	35.7 (1983 ff.)	250	34	8
Burkina Faso	15.5	-17	61.2 (1994)	240	32	11
Cambodia	11.9	-10	n.a.	260	62	12
Sierra Leone	16.2	-8	57.0 (1989)	130	126	5
Niger	14.4	-6	61.4	190	55	10
Kyrgyz Rep.	13.5	-21	n.a.	300	53	5
Madagascar	13.5	-8	60.2 (1993)	250	89	15
Mali	13.5	-12	72.8 (1994)	240	84	11
Senegal	10.8	-7	26.3 (1995)	510	58	9
Tanzania	12.5	-4	19.9 (1993)	240	71	33
Central Afric. Rep.	11.6	-7	66.6 (1993)	290	55	4
Zambia	11.4	-11	72.6 (1996)	320	181	10
Haiti	10.5	-18	n.a.	460	16	8
Papua N. Guin.	10.4	+1	n.a.	800	69	5
Chad	10.0	-18	n.a.	200	38	7
Total						196
Low income countries	0.7	-1		410		
Sub-Sahara Africa	4.1	-2		500		

^a poverty line 1 US \$ per person per day n.a.: data not available - Source: World Bank 2000a, own calculations

²⁴ Here official exchange rates are used for comparison, not purchasing power parities.

At the time being, these countries are not yet ready for development, they are just trying to survive. They are *transfer economies* with a very high trade deficit, mainly caused by financial inflows (development assistance and other foreign liabilities). The majority of them are highly indebted. Some of them fell in this situation due to wars or natural catastrophies, in others due to a gradually increased current account deficit during a longer period. Higher foreign aid might help them to survive somewhat better but it would be a further step away from self-reliance and self-sustaining growth. Of course, in this group of small countries it is certainly possible (and not beyond political realism, as in the country group of table 6.1) to sustain and expand foreign aid for the poor.

This group of countries is – at the time being - not ready for sustained growth mainly because of three reasons:

These countries are mainly subsistence economies with a very low degree of “marketisation” and “monetisation”, in other words the money- and market-based sector (private market economy and government sector) is small relative to the population. Under modern conditions such economies suffer from extreme hardships if there is no external aid. In larger LDCs (such as India or China), where the weight of the monetised, market sector is larger, the necessary assistance can be provided by this sector or the domestic government but not in the countries in question.

Under such conditions these countries are not able to guarantee the subsistence level of the population without massive foreign assistance relative to GDP.

These countries are faced with extreme balance-of-payment deficits, which is a type of macroeconomic imbalance that, under normal conditions, directly leads to extreme financial crises.

In this country group a positive pro-development macroeconomic environment as described in the previous sections does not exist. Even in terms of what “chapter 6” of the sourcebook defines as macroeconomic balance these countries are in severe imbalance. Whether they are hopelessly and permanently trapped as some development economist believe or not, we do not analyse here. We believe they have good chances in the medium and long run. Our salient point is: if they search for a chance for true development, they must become capable of finding step by step a path with reduced current account deficits, less inflows of debt and transfers and more domestic financial stability.

It is one of the shortcomings of chapter 6 of the sourcebook not to differentiate between these two different country groups. The rest of the sourcebook mainly addresses those very poor countries, while the chapter on macroeconomic stability refers to poverty reduction in *all* developing countries. In this country group it is simply impossible to call for macroeconomic stability (as the sourcebook does in chapter 6 or as we do in this paper): these countries are characterised by severe instability (mainly because of the balance of payment deficits) which cannot be changed in the short and the medium term. Therefore there seems to be a large blank area in the macro-economic concept of the sourcebook: how can a gradual development process beyond mere emergency help be launched, under conditions of a longer period of extreme macroeconomic imbalance? Country-specific strategies must identified. Further research is urgent.

5 Conclusions

The macroeconomic approach in „chapter 6“ of the sourcebook is based on the following explicit and implicit assumptions.

Growth is regarded as the main instrument for reducing poverty in LDCs. Although the relation between growth and poverty depends on the country-specific income distribution, in this respect we agree that growth is a decisive factor for development and poverty reduction. But redistribution and the supply of public goods for the poor must be emphasised more than the sourcebook does. One of the central questions is how to stimulate growth and how to push the country onto a sustainable long-term growth path. The authors of „chapter 6“ stress the following key points to achieve these aims:

The basis for growth is seen in the optimal allocation of resources. This means that the free play of the system of relative prices including an optimal incentive system - for example private property - is seen as the backbone of development for LDCs. Thus the economy is analysed along the lines of neoclassical economic theory, with a focus on the „real“ sphere of relative prices.

It follows from the argument under a) that the relation between *ex ante* investment and *ex ante* saving is seen from the side of saving. Saving determines investment. Following such a model, it follows logically that foreign saving can augment domestic saving in LDCs so as to stimulate investment and development. The argument of a saving gap in LDCs rests on the assumption that domestic saving is a finite „pot“ and that it cannot be increased domestically.

According to „chapter 6“ macroeconomic stability is a precondition for development in LDCs. Price stability with no more than moderate inflation is the basis for macroeconomic stability. This is, it is argued, only possible if monetary policy follows a nominal anchor - a growth rate of a monetary aggregate *or* a nominal exchange rate aim - and the budget deficit is sustainable. In addition, to secure macroeconomic stability, foreign debt and the current account deficit are not supposed to exceed a sustainable level, although the precise limit to such imbalances is seen as a “grey area”. Everybody will agree. It is obvious that high inflation rates, unstable exchange rates or over-indebtedness in foreign currency will prevent growth and development.

To take the arguments a) to c) together, the classical-neoclassical distinction between a „real“ sphere and a „monetary“ sphere becomes obvious. The latter has to be stable otherwise it becomes a disturbing factor for the real sphere. Money matters only in so far as it might act as a disruptive factor and is unimportant if sound monetary and other macroeconomic policies are followed. But macroeconomic policy is seen to have a huge negative impact on the real sphere if it is unstable. This is the basic theoretical vision of the authors of „chapter 6“. That is the explanation why growth policy is centred around *structural policies*, i.e. the improvement of allocation, and a net inflow of physical resources.

We have a quite different vision how to create growth. The key point, and at the same time the most difficult point to achieve, is how to stimulate investment. A precondition for a long-term growth process is the *stability* of „macro“ prices, that means the price level, the level of unit-labour cost, the nominal interest rate and the nominal exchange rate. But the stability of these macro variables is not enough to create growth as a set of additional conditions must be met. Macroeconomic stability has to be understood in a broader sense than in the sourcebook: it is not just the absence of endogenous shocks and severe macroeconomic imbalances; it includes also the full use of all the factors of production, labour included. Therefore, macroeconomic stability implies a stable growth of GDP. Macroeconomic policies should stimulate and support growth. So there is a role for *active* macro policy. “Chapter 6” follows a *passive* macro policy guideline: Preventing shocks and excessive imbalances is seen as sufficient (and even this is limited to the issues of inflation and budget deficits, without addressing the question of current account deficits or exchange rate fluctuations). The rest is to be achieved by microeconomic policies. We consider that this is theoretically false and results in a politically very risky imbalance between macro- and microeconomic policies that is of great significance for the ability to combat poverty.

We believe that three factors are of paramount importance for economic growth.

a) First, there must be *sufficient effective demand*. Capacity will only be used if there is demand to produce for. Investment will only take place when the expected future cash-flow is sufficient to cover current investment costs and generate a positive rate of return. When effective demand becomes a key point, then it follows:

Even an abundant stock of physical resources is not sufficient to induce production. If there is no demand even the richest endowments will lie idle. This can be seen in developed countries and as well in LDCs. It follows that net inflows of resources, or current account deficits, may increase the endowment of a country but there is no theoretical argument why these additional physical resources will increase production and investment.

Export demand may be the best source of demand to stimulate investment. If a country has a rapid internal investment dynamics then aggregate demand will be high and development has already started. What happens if investment demand is low? Can it be compensated by high consumption demand? This is not very likely as low investment will lead to low growth and low income and in the end to low consumption. Government demand could increase. But this implies budget deficits that lead to government debt. In LDCs high budget deficits may be difficult to finance - except by central bank credits which can become inflationary. Export demand has no negative domestic effects. If a country has a current account surplus the rest of the world will become indebted and not the government or other domestic sectors. Increasing current account deficits, *ceteris paribus*, reduces domestic demand. Why should firms increase investment?

The authors of „chapter 6“ are in favour of a „flexible“ fiscal policy and reject numerical limitations for the budget deficit. We agree.

The authors argue that there is room for foreign grants and foreign credits to finance government expenditures, for example for the poor. However, they do not sufficiently analyse potential negative macroeconomic effects of financing the budget with foreign funds.

We come to the conclusion that foreign funds for specific purposes - especially grants - can be very helpful for governments in LDCs. Foreign funds can have a positive effect if foreign goods that are not available domestically have to be bought since this will not crowd-out domestic goods. The classical case of this type of help is the delivery of goods after natural disasters. In addition, the reduction of foreign debt is positive as debt-service in foreign currency is reduced and the fiscal room for manoeuvre is increased. Foreign funds to finance domestic government expenditures are not necessary, apart from emergency assistance. They can affect negatively the money supply and/or can create current account deficits with a negative impact on domestic demand and production.

b) Second, private-sector investment will only flourish if there is a positive *state of confidence*. In general, nothing very definite can be said about the state of confidence as it is influenced by country-specific economic, social and political factors. But two things are clear: First, there are no theoretical and empirical grounds for believing that improved efficiency on a micro level will improve the state of confidence and stimulate investment; second, of paramount importance for the state of confidence is the *reputation of the national currency*. If the majority of economic agents wish to keep their wealth in foreign currency then investment will not be high. In such a case, accumulation in foreign wealth is preferred to the accumulation of wealth in the domestic currency. Parallel currency systems or dollarisation are clear signs that the domestic currency has a poor reputation, and of a lack of domestic investment. The domestic currency becomes marginalised.

A nominal exchange-rate anchor serves not only to give monetary policy a clear aim and to provide a measure of its „efficiency“. It also serves the aim of showing that the national currency can compete with foreign currencies. A history of a stable nominal exchange rate reduces the likelihood of dollarisation and increases the likelihood of high investment. A higher reputation also gives the central bank room for manoeuvre to lower interest rates. Finally, if the national currency has a higher reputation it stimulates the development of the domestic asset and especially credit markets. The latter is important for entrepreneurs to find cheap funds for investment.

If we analyse the current account in this context we again come to the conclusion that current account surpluses (or at least a balanced current account) is a strong support for a positive development in LDCs. Surpluses effectively strengthen expectations regarding the stability of the currency. One reason for this is that devaluations and balance of payment crises become less likely and less dangerous.

c) Third, for development a strong government representing a “*development state*” is needed. The state has to support private investment in numerous ways.

It has to protect the internal credit market by capital controls, to protect infant industries by tariffs and subsidies, to foster pro-poor growth, to offer public goods and to take care of redistribution; it has to build-up a basic social safety net, to organise incomes policy and so on. Especially in a situation of sluggish private investment, the government can increase aggregate investment by public investment. This can be investment in infrastructure or investment by state-owned enterprises.

To sum up: If we compare our approach to reducing poverty with the approach of the authors of „chapter 6“ of the source book the main differences are the following:

We do not believe that markets spontaneously start to work for growth and poverty reduction if they are liberalised, an efficient allocation mechanism on the micro level is established and macroeconomic policy does not disturb the private sector that is conceived of as basically stable. An active demand management in LDCs is necessary. Economic policy should focus on stimulating exports and investment by preventing current account deficits, fighting against dollarisation and improving the credibility of the domestic currency. One of the basic preconditions for macro-economic stability is a balanced current account and a stable exchange rate, as mentioned. With-out capital market controls this seems impossible to achieve. Capital market liberalisation should be implemented at a much later stage of development.

Economic growth, even pro-poor growth, is essential but not sufficient for poverty reduction. Pro-poor public goods are necessary in the form of infrastructure to meet basic needs. These should consist mainly of domestic goods and services and should be paid for out of the budget or by fees. So tax increases and a pro-poor reallocation of public expenditures is needed. Foreign donations cannot substitute for domestic public expenditure if adverse macroeconomic effects are to be avoided. The case for pro-poor public expenditures financed by *domestic* sources seems to be undervalued in the sourcebook. However, on the use of debt-relief measures for poverty reduction we agree with „chapter 6“.

One of the shortcomings of the macroeconomic chapter of the sourcebook is the failure to differentiate between very poor, highly indebted and extremely dependent countries and other countries, mainly larger ones, with high numbers of absolutely poor, but less dependence on foreign assistance. More than 90% of the world's poor live in the latter category, while the former country group comprises mainly the small sub-Saharan economies with a dominant subsistence sector and extreme dependence on foreign aid causing huge balance-of-payments deficits. In the short and medium term, perhaps even in the long run, there is no chance for macroeconomic stability in these countries. The World Bank's call for implementing macroeconomic stability *in the same way in all* poverty-heavy countries is subject to a deep illusion; *different* strategies and policies are necessary. In the group of very poor countries, one must search for gradual and long-term oriented development strategies under medium-term conditions of severe macroeconomic *instability*. We are rather at a loss as regards confronting this problem and call for further research in the area.

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