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**Reading Material 12:  
Macro Trends in Africa**

# Macroeconomic Policies for Poverty Reduction in Africa

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...[I]nstitutional mechanisms for policy implementation are critical; that poverty reduction issues must be integral to the macroeconomic regime...  
(Ohiorhenuan, Wayem & Barungi 2004)

## 3.1 Fiscal Policy

A pro-poor macro framework for the sub-Saharan region must have three goals. It should: 1) raise the growth rate well above the rate of population increase, achieved by less than ten of the countries over four decades; 2) substantially reduce the variability of growth; and 3) foster a more equitable growth path.

The simplest element to specify is how to raise the growth rate. Setting aside exogenous factors such as weather effects, the major limitations to faster growth are 1) restrictive fiscal policy, 2) contractionary monetary policy, and, in most countries, 3) a balance of payments constraint. Converting a restrictive fiscal policy to an expansionary one would be achieved through an employment-intensive public investment programme, financed by borrowing or, one might hope, increased development assistance and debt relief. A growth-accommodating monetary policy requires using the interest rate as a long-term investment instrument rather than for short term stabilization; i.e., an end to inflation targeting. The balance of payments constraint could be relieved by interventions to establish a stable and moderately undervalued real exchange rate. Development assistance would provide support during the transition towards a stronger export performance. Each of these familiar tactics is discussed in detail below.

The major causes of growth instability for the sub-Saharan countries are: 1) fluctuations in the terms of trade, which impact directly on aggregate demand via export and import prices, affect the fiscal balance through trade taxes, and tighten or loosen the balance of payments constraint; and 2) variations in weather that largely determine the performance of rain-fed agriculture in a region where irrigation is limited. Both of these factors are beyond the direct management of sub-Saharan governments in the short and medium term, though the effect of the latter could be reduced in the long run by structural changes in the agricultural sector.

With few exceptions, African governments suffer from the ineffectiveness of policy instruments that might be used to counter growth instability. In more developed countries, fluctuations in foreign exchange flows can be partially absorbed through

open market operations by the central bank. Few African countries have bond markets sufficiently developed to use this instrument effectively. The absence of bond and equity markets also means that so-called market based capital controls are unlikely to be effective (e.g., taxes on private in-flows and out-flows). None-the-less, there exist policies that even low-income countries with underdeveloped financial markets can implement to reduce the impact of fluctuations in the terms of trade and weather.

At least three policy options are available. The first derives in part from changes emerging in the management of development assistance. As a condition for concessional lending from the World Bank and the International Monetary Fund, almost all sub-Saharan countries must prepare Poverty Reduction Strategy Papers.<sup>1</sup> One aspect of the process associated with these documents is that donors and lenders should simplify and coordinate their loans and grants, in part through moving from funding projects to budget support. Within this process, African governments could negotiate for longer-term commitments from donors and lenders, with a more predictable flow of funds. In some countries, with specific donors and lenders, this has occurred.<sup>2</sup> If assistance flows were predictable, they could be dispersed by governments in a manner to counter the domestic impact of changes in the terms of trade and unfavourable weather, as an alternative to the ineffective open market operations. Perhaps the most important function of ODA funds would be to manage the nominal exchange rate to reduce its fluctuations, a source of instability identified in numerous studies.<sup>3</sup>

Second, even in low-income countries fiscal policy can be used as a counter-cyclical instrument. However, in stabilization and structural adjustment programmes throughout the sub-Sahara, emphasis has been placed on deficit reduction, and fiscal policy has typically had a pro-cyclical impact. To the extent that this approach has any theoretical basis, it derives from a price determined in which the general price level automatically adjusts to maintain full employment. In addition to the real world improbability of the effectiveness of this adjustment mechanism, its theoretical validity requires the operation of the so-called real wealth effect, which can be shown to be logically faulted.<sup>4</sup>

Given the weakness of the underlying theory, it should come as no surprise that empirical evidence indicates that moderate deficits are not closely correlated with inflation, and that the impact of inflation on growth is ambiguous (discussed further below).<sup>5</sup> In addition to policy conditionalities, a practical constraint to counter-cyclical fiscal policy has been balance of payments pressure. By maintaining control over the currency conversion of development assistance, and using currency reserves to support the balance of payments in contractionary periods, governments could return fiscal policy to the counter-cyclical purpose recommended by generations of Keynesians.<sup>6</sup>

Third, ODA funds could also be used to support programmes that reduce the impact of changes of international prices on importers and exporters. For a small country price stabilization schemes for exports would reduce the volatility of production levels. However, attempts to compensate producers for the full effect of international price changes, for example via a fixed producer price, often prove to be too expensive to maintain in the long run. More modest price stabilization rules, supported by

development assistance, could have a substantial impact on terms of trade fluctuations.

Use of ODA in the manner suggested above would require donors and lenders to allow recipient governments to have control over the conversion of grants and loans into national currency, which is not the case in many African countries.<sup>7</sup> In effect, donors and lenders would have to accept exchange controls as a legitimate instrument of economic policy, as advocated by Lim (1999) for East Asian countries. At no resource cost to themselves, development agencies could make a major contribution to poverty reduction by allowing sub-Saharan governments to decide the most effective manner in which to manage their aid flows. As well as contributing to pro-poor growth, doing so would practice the principles of the PRS process, that recipient governments should have ownership of their policies.

Of the three goals, increasing the growth rate, reducing growth instability, and fostering a pro-poor growth pattern, the last is the most difficult given the structural characteristics of sub-Saharan countries. The fiscal policy in almost all stabilization and structural adjustment programmes is pro-cyclical, when it is not continuously contractionary, constraining growth below potential. Reversing this policy is not a simple matter of increasing expenditure. A growth-fostering *pro-poor* fiscal policy package requires more public expenditure of a particular type: public investment, which can achieve the three necessary elements of such a package, demand expansion, supply enhancement, and redistribution.

In the absence of a robust public investment programme, the pro-poor element in fiscal policy would consist of social expenditure, counter-cyclical measures, and progressive taxation. While each of these is important, in many developing countries the capacity to intervene counter-cyclically is limited, and progressive taxation non-feasible for most of the population. The progressiveness of the tax system is determined in the sub-Saharan region by the relative low contribution of the 'formal' sector to income generation, and redistributive current expenditure may be beyond the administrative capacity of the public sector.

Even more important, basing redistribution on the current budget is not a growth strategy. If sustained, it may create a new, more equal distribution which the economy will approach. However, except for a possible one-off impetus resulting from the positive incentives to the poor of the redistribution, it has little impact on the sustainable growth rate. For this reason, public investment is the *sine qua non* of a pro-poor growth strategy, and the reduction of public investment undermines that strategy.

The emphasis placed on public investment requires consideration of one of the major arguments against it, so-called crowding out.<sup>8</sup> The argument that public investment in Africa would crowd out private investment is somewhat surprising. It is typically the case that those who make this argument also urge governments to undertake major policy changes to encourage inflows of foreign investment, usually without expressing strong concern that the latter might crowd out private domestic investment.

In general, 'crowding out' occurs when an economy is near full employment. When there are unutilized resources, there is economic space for an increase in all types of

expenditure, both public and private. Even if ‘crowding out’ occurs in under these circumstances, it is unlikely to be complete. That is, the elasticity of private investment with respect to government expenditure of any type will be less than minus one. As a consequence, public investment would be growth-inducing both in its demand and capacity effects unless the return on the marginal private component were sufficiently higher than on the public component such that the growth impact were negative. This can be shown formally using the simple Harrod-Domar model, where  $y$  is the rate of growth,  $v$  is the incremental capital-output ratio, and  $i$  is the share of investment in output. Let the subscripts  $pr$  and  $pu$  be private and public investment, respectively, and 0 and 1 be two time periods. Without public investment, the warranted (potential) rate of the economy is:

$$y_0 = [v_{pr}]i_{pr0}$$

Let the ‘crowding out’ ratio be  $\alpha$  (the fraction by which public investment reduces private investment), and the private output-capita ratio be the same in both time periods. Then, the new growth rate with public investment is:

$$y_1 = [v_{pr}][i_{pr0} - \alpha i_{pu1}] + [v_{pu}]i_{pu1}$$

We can compare the two scenarios by subtracting  $y_0$  from  $y_1$ :

$$y_1 - y_0 = i_{pu1}[v_{pu} - \alpha v_{pr}]$$

Crowding due to the introduction of public investment will reduce the rate of growth if and only if,  $v_{pu} > \alpha v_{pr}$ ; in other words, only if public investment is more capital using than private investment by the ratio of crowding out. If the capital-output ratio for public investment is smaller than for private investment, public investment never reduces the growth rate, no matter what the value of  $\alpha$ , assuming its upper limit to be unity (‘total crowding out’, one hundred percent). If crowding out is total, the growth rate falls only if public investments are more capital-using than private ones. Thus, public investment having a negative impact on the capacity-creating source of growth occurs only under the very restrictive conditions in which crowding out is total and private investments use less capital per unit of output. The former is unlikely and the latter can be avoided by public choice of investment projects. The considerable work that has been done on employment intensive public works can provide practical guidelines to ensure that public investments are not excessively capital using. Theory and practice suggest that ‘crowding out’ is unlikely to have a negative impact on growth.

As a final observation on crowding-out in the sub-Saharan region, a substantial part of private sector investment either does not borrow for investment, or does not do so in the financial markets that would be affected by government borrowing. Investment by small producers, rural and urban, is often self-financed, or financed from indigenous lenders with little connection to the formal banking system. In addition, foreign investment, to the extent it is important, is not typically financed from domestic financial markets.

## 3.2 Monetary Policy

### 3.2.1 Orthodox ‘Inflation Targeting’

Perhaps the most concrete (and pernicious) application of the price determined framework manifests itself in the policy of ‘inflation targeting’. Within this

framework, every economy is presumed to be in or moving toward general equilibrium and inflation is the result of expectations and ‘random shocks’. In other words, inflation has no structural cause; it follows from people’s anticipation of it, and these anticipation are primarily the result of government behaviour. In its most inflexible form, inflation targeting involves assigning to the central bank the mandate to use its policy instruments to realize an inflation rate within a specific range, or, more extreme, below a specific rate.<sup>9</sup> The instrument to ‘hit’ the target is almost always the nominal interest rate. In practice, attempting to fulfil such a mandate overrides all other policy objectives, be they short, medium or long run; i.e., achieving a competitive exchange rate, stimulating investment, and managing the budgetary cost of the government’s debt.

The major argument in favour of inflation targeting is that its success, a low inflation rate with a small variation, would foster growth by providing a stable macro environment for private investment. There are two issues here: the effect and wisdom of targeting as such; and the inflation rate to be targeted. These issues have been addressed comprehensively by Saad Filho (2005) in a training module for this project, and are not repeated here. For purposes of this paper, it can be pointed out that consideration of the alleged positive benefits of inflation targeting requires a prior acceptance that the policy is feasible; i.e., that most central banks in the sub-Saharan region could by use of the monetary instruments available to them realize a pre-determined rate of inflation and maintain it with small variability.

This proposition is not credible, because of the large and unavoidable stochastic (random ‘shock’) element in policy outcomes. For example, during 1980-1999, the average annual terms of trade shock across forty-two sub-Saharan countries equalled 4.5 percent of GDP, with a standard deviation of 5.4.<sup>10</sup> For the average regional economy with a trade sector of one-third of GDP (average of the export and import shares), this would imply an annual average price ‘shock’ of 1.5 percent. However, since the standard deviation is so large, there would be a thirty-three percent probability of a positive shock up to three percent in any year. In other words, an inflation target of five percent, for example, would exceed half the time (by the definition of randomness), and be double rate ten percent of the time. Should the mandate demand five percent or less in most years, the *de facto* target would have to be well below the mandated target. This implies an institutionalization of high nominal interest rates, which would translate into demand-compressing real interest rates.

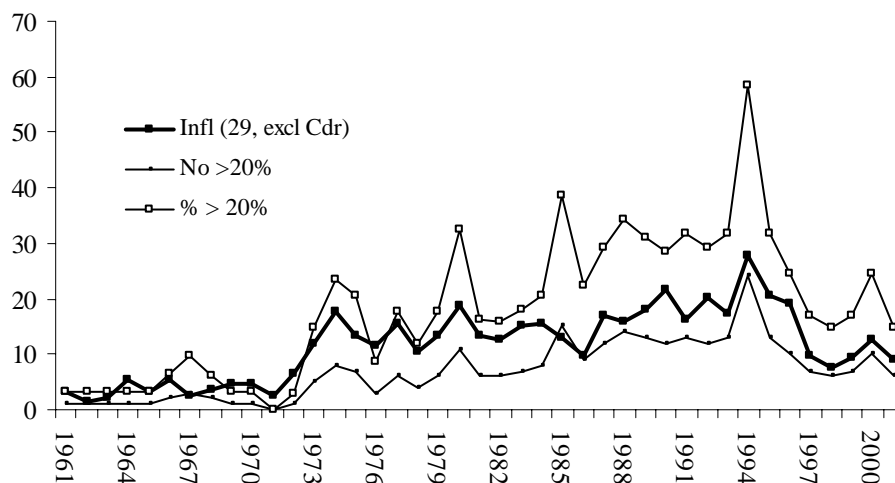
In the context of such large and persistent terms of trade shocks, not to mention weather-related shocks, it would be impossible for the central bank to achieve the basic goal of a stable and predictable rate of inflation. But, could it be argued that inflation has been so serious in the sub-Saharan countries that targeting it is required to bring the rate down, even if stability is beyond policy?

Despite the recessionary consequence of choosing a low numerical target and attempting to achieve it in the context of severe and systematic random shocks, many external assistance agencies vigorously defend the policy for inflation reduction as such. What might be called the ‘bottom line’ defence is that ‘inflation is bad for the poor’; therefore, inflation targeting is ‘good for the poor’. This allegation appears repeatedly in IMF and World Bank documents. There is little evidence to support it.

In one of the few empirical studies of the distributional impact of inflation, Galli and van der Hoeven found that ‘[t]hough in high inflation countries restrictive monetary policy is often beneficial for inequality, reducing inflation in economies with initially low inflation might increase inequality’ (Galli and van der Hoeven 2001).

If practical knowledge of sub-Saharan economies leads one to the conclusion that inflation targeting is doomed to fail by its own criterion because of random shocks, inspection of economic performance reveals that if the goal is to reduce the average rate of inflation, targeting is not necessary. Figure 3.1 shows inflation rates for twenty-nine sub-Saharan countries over forty years, 1961-2001.<sup>11</sup> At first inspection, it would appear that after a period of very low inflation into the early 1970s, the countries of the region began to display strong inflationary pressures, with a notable reduction in the second half of the 1990s.

Figure 3.1:  
Inflation over 40 Years in the Sub-Saharan Region, 1961-2001



Source: *World Development Indicators 2003*, ‘GDP Price Deflator’.

Notes:

Infl (29, excl Cdr) = average annual inflation for all the countries with continuous data, 1961-2001, excluding the Democratic Republic of Congo.

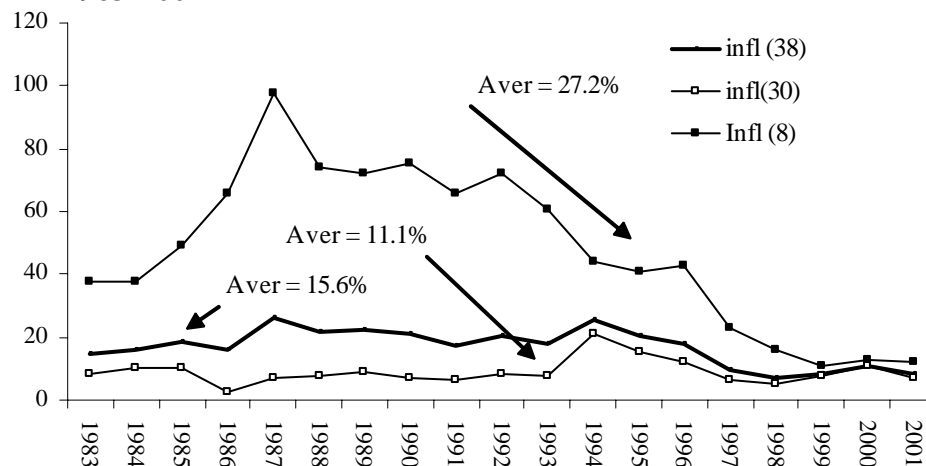
No>20% = number of countries with inflation rates over twenty percent, for all countries with data in a given year (maximum of 42).

% > 20% = percent of countries with inflation rates over twenty percent, for all countries with data in a given year.

However, expanding the number of countries and disaggregation yields a quite different conclusion, as Figure 3.2 shows. In practice, the sub-Saharan countries were divided into three groups for inflation performance: two hyper-inflation countries (Angola and the Democratic Republic of Congo, not shown in the chart), eight inflation-prone countries, and thirty moderately low-inflation countries (see notes to the chart, where the countries of the second third categories are listed).<sup>12</sup> An inflation rate of less than ten percent two-thirds of the time, the experience of the moderately low inflation countries of the region, would not seem to justify shackling monetary policy to so-called price stability. This judgment is reinforced by the convergence of the high inflation countries to the level of the low inflation countries. This convergence across countries of different sizes, economic structures, and past

performance, suggests inflationary pressures have declined for the entire region, perhaps due to a less inflationary external environment.

Figure 3.2:  
Convergence of Low and High Inflation Sub-Saharan Countries,  
1983-2001



Source: *World Development Indicators 2003*, 'GDP Price Deflator'.

Infl (38) = average annual inflation for all countries with continuous data, 1983-2001.

Infl (30) = average for Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Republic of Congo, Cote d'Ivoire, Ethiopia, Gabon, the Gambia, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Namibia, Niger, Nigeria, Rwanda, Senegal, Seychelles, South Africa, Swaziland, Togo & Zimbabwe.

Infl (8) = Ghana, Guinea-Bissau, Mozambique, Sierra Leone, Somali, Sudan, Uganda & Zambia.

We can conclude that inflation targeting fails as monetary policy for the sub-Saharan region on all counts: 1) in as far as it seeks to stabilize the rate of inflation, it is not feasible; 2) if it merely seeks to lower the average rate of inflation, it is unnecessary in the vast majority of countries; and 3) by its inherently contractionary consequences, it is anti-poor.

### 3.2.2 'Real Targeting'

If inflation targeting is anti-poor, might that be other variables that if targeted would contribute to a pro-poor growth path? It is important in this context to distinguish between a commitment to an outcome, and assigning it as a mandate to an agency of government. In the latter case, if the target is binding in the sense of requiring specific policy action, the possibility arises that attempting to achieve it may be inconsistent with other policy outcomes.

While in principle 'real targeting' has its attractions for a pro-poor macro framework, it suffers from two major problems: 1) the relationship of the target to policy instruments; and 2) the feasibility of such targeting by sub-Saharan governments. The fundamental goal of a pro-poor macro strategy would be poverty reduction, but this

cannot be targeted in an operational manner. It would be futile to have annual poverty targets, because the incidence of poverty fluctuates in response to many short term changes over which the government has limited or no influence. It is generally recognized that poverty reduction is a long term process. If poverty targets are set for a longer period, the issue of short term policy priorities remain, and poverty targeting is indistinguishable from a commitment to the MDGs.

On a purely technical level, poverty targeting, as opposed to monitoring growth for its poverty impact, is not possible as a macro policy mandate. Governments, in the sub-Saharan region or elsewhere, have no macro instrument that directly acts on poverty. While the same could be said for inflation (the interest rate impacts on the cost of borrowing, not inflation itself), the links between macro instruments and poverty are many and contingent.

Superficially appealing is the suggestion that real output might be the mandated target. While some macro instruments have a direct impact on real output, for the sub-Saharan countries the stochastic component of aggregate output is so great that setting this target is non-operational. Targeting real output also suffers from the problem of conflict among policy objectives. Try as a government might, it will inevitably face circumstances in which it is necessary to constrain real output to prevent an even larger decline. This might be necessary in face of an unsustainable trade deficit or excessive inflation. In such circumstances, macro policy requires a flexible mandate, what Saad Filho calls ‘constructive ambiguity’ (Saad Filho 2005).

In summary, the structural characteristics of sub-Saharan countries make mandated targeting either infeasible or undesirable, or both. Feasible and desirable would be a political commitment to poverty reduction, such that each aspect of macro policy was assessed *ex ante* and *ex post* for its poverty impact, and these assessments be subject to public scrutiny. One manifestation of the commitment could be a poverty assessment of the annual budget.

### **3.2.3 Pro-poor Monetary Policy**

Liberated from the straight-jacket of inflation targeting, monetary policy could contribute to pro-poor growth. Used as the major instrument for macro management, monetary policy can do little to make growth pro-poor. However, in support of an expansionary fiscal policy it can indirectly foster growth that is pro-poor. As a general rule, if inflationary pressures are weak, this support would take the form of positive but low real interest rates and an expanding monetary supply.

While these seem simple guidelines, foster growth and counter inflation when necessary, their application in sub-Saharan countries is not straight-forward. In most of the countries of the region, financial markets are underdeveloped. Indeed, in a few countries, the monetization of the economy is low.<sup>13</sup> The concrete result of underdeveloped financial markets is that governments find it difficult or impossible to sell their bonds to private agents. This explains the common practice in the region of legislation that requires commercial banks to hold a portion of their reserves in government bonds. In practice this requirement has tended to have an anti-poor bias, as discussed in Section V in the context of domestic borrowing. The narrow bond

market also implies that deficit spending, if financed domestically, tends to be covered by monetization (selling bonds to the central bank).

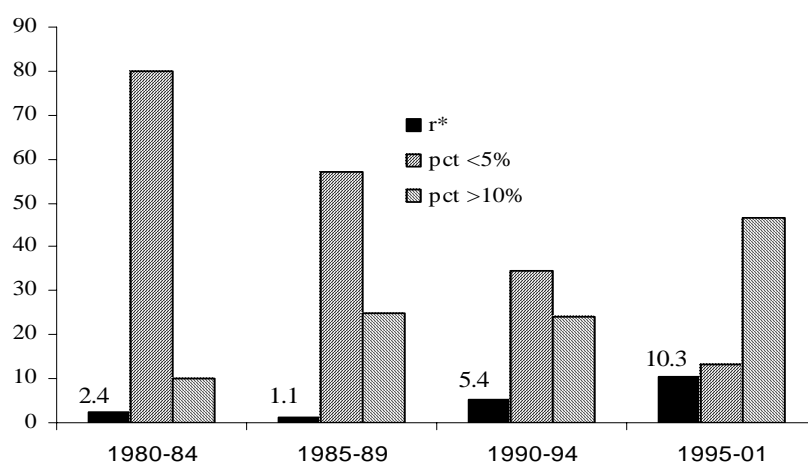
Wisely or unwisely, most sub-Saharan governments have granted autonomy for central banks to make decisions about the policy instruments which are within their mandate (Ethiopia is an exception). The most used instrument in the hands of the central bank is the rate at which it lends money to commercial banks, often loosely called 'the interest rate'. Manipulating this rate is alleged to be an effective manner in which to achieve two policy outcomes, price stability and exchange rate stability. It would achieve price stability by: 1) provoking a commensurate change in the commercial bank lending rate; 2) that this would lower or raise the cost of borrowing; 3) a change in the cost of borrowing would increase or decrease the demand for credit; and 4) then, the supply of money would adjust to the demand. The alleged mechanism for stabilizing the exchange rate is more direct: 1) provoking a commensurate change in the commercial bank deposit rate; and 2) this attracts or repels foreign capital deposits, which by definition increases or decrease foreign exchange reserves.

These mechanisms do not operate effectively in most sub-Saharan countries. The amount of commercial lending for fixed investment is typically low, allegedly for risk reasons. More often the lack of interest in lending for productive investment is because the high returns on government paper (due in great part to inflation targeting), and the faster turnover of loans to finance imports and exports. Therefore, attempts to stimulate private investment by lower interest rates are unlikely to have a substantial impact. Further, many countries are characterized by enormous spreads between the central bank rate and the commercial lending rate (and between lending and deposit rates. As a result, to induce commercial lending rates down to a level to stimulate investment is not feasible, perhaps requiring negative *nominal* central bank rates. Finally, most private productive investment is not financed through the commercial banking system either because it is by small operators, both rural and urban, or because foreign investors raise their funds abroad where interest rates are lower.

Notwithstanding the limited role played by interest rates in most sub-Saharan countries, their levels since the mid-1990s have represented a massive price misalignment ('distortion' to use the neoclassical term). This is shown in Figure 3.3. Because data on interest rates are incomplete, averaging across countries can be misleading on its own. Thus, the chart shows the cross-country average real commercial lending rate for countries with data ( $r^*$  in the chart). It also gives two other statistics: the percentage of countries covered in which the rate exceeded ten percent and the percent in which it was below five percent. Five percent can be taken as an estimate of a standard rule of growth theory, that the long term real interest rate should not exceed the maximum sustainable rate of growth of per capita income. If we divide the 1980s into two halves, eighty and sixty percent of countries, respectively, had real rates below the growth-constraining maximum, and only ten and twenty percent above it.

Figure 3.3:

Real Commercial Lending Rates for Sub-Saharan Countries,  
and Percentage of Countries in Ranges, 1980-2201



Source: *World Development Indicators 2003*. Variable is defined as ‘the lending rate adjusted for inflation measured by the GDP deflator’.

Thirty countries, with numbers in parenthesis noting periods for no data (periods numbered 1 to 4): Botswana, Burundi, Cameroon, Cape Verde (1), Central African Republic, Chad, Rep of Congo, Eq Guinea (1), Ethiopia (1), Gabon, Gambia, Guinea (1), Kenya, Lesotho, Liberia, Madagascar (1), Malawi, Mauritius, Mozambique (1-3), Namibia (1&2), Nigeria, Sao Tome & Principe (1), Seychelles (1), Sierra Leone, South Africa, Swaziland, Tanzania (1), Uganda, Zambia & Zimbabwe. The two hyper-inflation countries, Angola and Congo DR, omitted.

Subsequently the average rate rose dramatically, to over five percent in the first half of the 1990s, and over ten percent for 1995-2001, with almost half of the thirty countries suffering from real lending rates in double figures. Were private sector wage rates misaligned to this degree, by one hundred percent, it would be judged as a severe obstacle to employment growth. It is surprising, therefore, that development assistance agencies have not criticized the misalignment of interest rates; on the contrary, some have sought to defend it, on a ‘risk’ argument. If it is the case that commercial lenders are so risk averse in sub-Saharan countries that they can only be induced to loan by charging punitive interest rates, the prospects for increasing domestic lending for private capital accumulation are bleak.

Returning to the earlier discussion of interest rates and private investment, the limited ability of the central bank to stimulate investment does not imply there is no pro-poor role for the central bank rate. Lower central bank rates would have two pro-poor effects: 1) government bonds are held by the wealthy, or the institutions of the wealthy, so lowering rates has a positive impact on income distribution; and 2) lower rates imply a smaller domestic debt service in the public budget, producing ‘fiscal space’ for pro-poor government expenditure.

Allowing the money supply to expand faster than real output can also have a pro-poor impact, by increasing access to credit in ‘informal’ financial markets.<sup>14</sup> It also encourages financial ‘deepening’; i.e., the ratio of the money supply to aggregate output, which is typically low in sub-Saharan countries. Money supply management raises the question of what instruments would be used to counter inflationary pressures, if these became a serious policy concern. The key policy issue is what

constitutes ‘a serious concern’. Cross-country regressions suggest that inflation is uncorrelated with growth for the rates that characterize sub-Saharan countries (Easterly & Bruno 1998); i.e., rates below forty percent. Therefore, if growth and poverty reduction are the goals, a tolerance for moderate inflation is required. This is especially the case because due to the weakness of financial markets, the only effective instrument for reducing inflation in most countries would be fiscal contraction.

In summary, a pro-poor monetary policy requires low real interest rates, a tolerance for moderate inflation rates, and an expansion of the money supply that accommodates growth and financial deepening. To achieve these outcomes, it is probably the case that it would be more pro-poor to finance prudent fiscal deficits by monetization than by bond sales, which redistributes income to the wealthy.

### 3.3 Exchange Rate Policy

The current orthodoxy that exchange rates should be determined in an unregulated foreign exchange market, that they should ‘float’, is a marked reversal of the previous orthodoxy for twenty-five years. During 1945-1970, all members of the IMF were signatories to an agreement that governments would maintain a fixed rate, usually to the US dollar, and inform the IMF of intentions to devalue or revalue.<sup>15</sup> The system of fixed exchange rates broke down not because of a change in judgement about its effectiveness; on the contrary, attempts were made to extend its life when its imminent demise was obvious. Given the strength of the fixed exchange rate orthodoxy had before the early 1970s, it is difficult to avoid the conclusion that the acceptance of the theoretical arguments for ‘flexible’ rates represented making a virtue of necessity.

The orthodox arguments for fiscal austerity (balanced budgets) and tight monetary policy allege that these indirectly benefit the poor, by fostering macroeconomic stability. In as far as this might be true, one would conclude that the poor would benefit no more than the population as a whole, so strictly speaking these policies would not be pro-poor. In the case of flexible exchange rates, the orthodox argument is that they benefit the poor directly, and more than the non-poor. The argument, which is made for underdeveloped countries in general and especially the sub-Saharan region, goes as follows: 1) the majority of poor households are rural, deriving their livelihoods directly or indirectly from agriculture; 2) agricultural commodities are tradables; 3) real currency depreciation raises the prices of tradables relatively to non-tradables; and 4) flexible exchange rates result in real currency depreciation.<sup>16</sup>

For sub-Saharan countries the first and last steps in the argument are generally valid. In only a few of the countries is a majority of the population urban, and in none is a majority of the poor. Almost all the countries suffer from balance of payments pressures, and opening the capital accounts has not, and is unlikely to, result in capital inflows that prompt appreciation (as has occurred in Latin American countries). However, the second and third are of dubious validity. Tradability is not determined simply, by international markets for similar products. As Liang (1992) argued, a commodity is a tradable only if it is a close substitute in the international market, and if transport costs are not prohibitive. Many of the major products of small farmers in

the sub-Saharan region are not close substitutes to international products,<sup>17</sup> and the producers are so far from transport and marketing challenges that even close substitutes cannot in practice be traded internationally.

While in theory a real devaluation should increase the price of tradables, if domestic markets are inefficient, the relative price change can be slight. Even more important, in many sub-Saharan countries a large portion of the poor, both urban and rural, may be net food buyers, in the latter case because they are agricultural day labourers. The net impact of a rise in the relative price of tradables on poverty cannot be determined *a priori*. None-the-less, the export promotion effect of a real devaluation would be a key part of a pro-poor exchange rate policy. In other words, the possible negative impact on poverty due to higher food prices in the short term is of secondary importance to the medium and long term need to relieve the balance of payments constraint. To reduce that negative effect, devaluation could be combined with food subsidies, which are consistent with WTO rules. This combination of policies would require the fiscal space to fund the subsidies, an issue treated in the next section.

The appropriate exchange rate regime for promoting exports would be the well-known 'crawling peg', in which the government pursues managed nominal devaluations. There are several advantages of this regime over a one-off devaluation followed by non-intervention, which seeks to jump to some unique 'equilibrium' exchange rate. First, the view that economies have a unique, market-determined exchange rate which strikes the correct balance between tradables and non-tradables is incorrect in practice. As discussed above, a substantial portion of a country's foreign exchange flows may not be market related (development assistance and debt service), so that the so-called market rate would not reflect the appropriate relative price of tradables even in theory. Second, the practical purpose of devaluation is to lower the foreign currency price of a country's exports. If the inflationary effect of the devaluation is contained, the purpose should be achieved in the short run. However, if the trading regime is a liberal one, as in most sub-Saharan countries, the domestic currency price of exportables will slowly approach the international price (the so-called Law of One Price). Because of the lag in the price adjustment, periodic nominal devaluations can maintain a wedge between the export price in domestic currency and the world price.

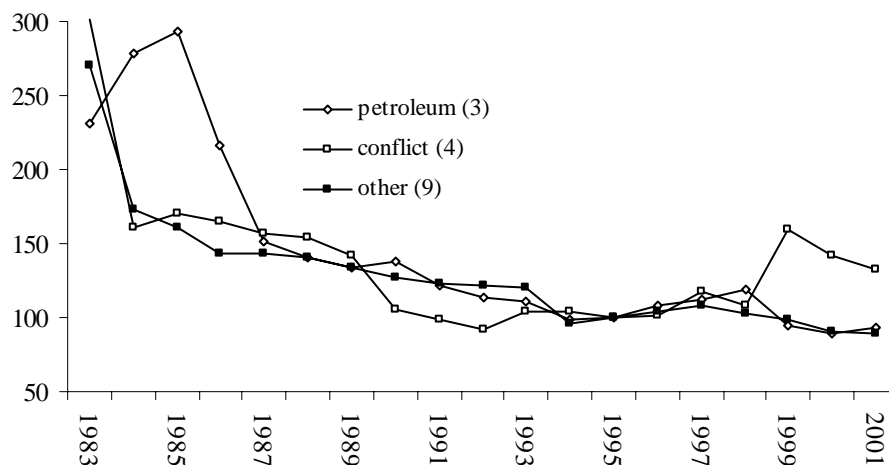
Statistics from a few countries suggest that real exchange rates have not been seriously misaligned in the sub-Saharan region since the early 1980s (see Figure 3.4, where the countries are divided into three groups). From 1983 through 1993, the measure in the charts showed a continuous devaluation, quite large for all three groups, petroleum exporters, conflict affected, and the others. During the ten years that followed real exchange rates were virtually stable for all sixteen countries. One can draw only tentative conclusions from statistics covering less than half the countries of the region, but it is suggestive to compare exchange rate movements to export performance. In Table 11 growth rates of constant price exports are shown for the same three country groups. Perhaps the most surprising result of the table is the discovery that export growth over the nineteen years was almost identical across the groups, and low compared to the growth of world trade for the same period.<sup>18</sup> In other words, for this incomplete coverage, it made no difference on average if a country was a petroleum producer, conflict affected, or neither of these. One major difference across the groups was the variation in export growth. For the petroleum

exporters and conflict affected countries, the coefficient of variation was over two (approaching three for the latter), and only slightly over unity for the other countries.

Comparison of Figures 3.4 and 3.5, especially for the ‘other’ countries, suggests that a depreciating exchange rate was insufficient to foster a rate of export growth that could support GDP growth rates that would reduce poverty. An exchange rate that would make exports competitive should be combined with public investment to reduce transport and other costs, and a purposeful industrial policy. Industrial policy lies beyond the scope of this paper on macro policy. However, we can suggest that achieving satisfactory export growth rates requires such a policy in all sub-Saharan countries.

Figure 3.4

Real Effective Exchange Rates, 16 sub-Saharan Countries  
by Group, 1983-2001



Source: *World Development Indicators 2003*. Variable is ‘the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs’.

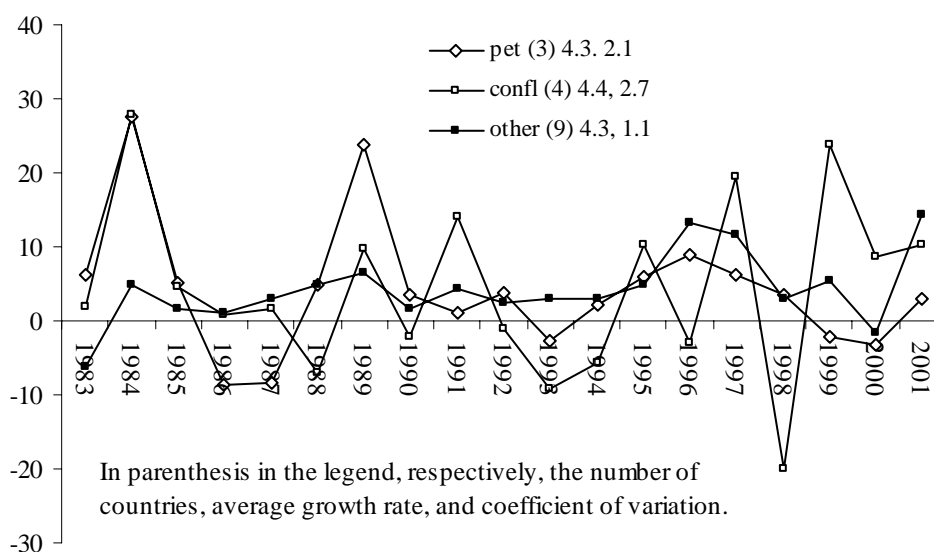
Petroleum: Cameroon, Gabon, Nigeria;

Conflict: Burundi, Congo DR, Sierra Leone, Uganda

Other: Central African Republic, Cote d’Ivoire, the Gambia, Ghana, Lesotho, Mali, South Africa, Togo, Zambia.

Figure 3.5:

Rates of Export Growth, Categories of sub-Saharan Countries, 1983-2001



A final, extremely important comment is required on exchange rates. At the beginning of this section we pointed out that the IMF was created to oversee a system of fixed exchange rates. The principal purpose of the system was to prevent the recurrence of the competitive devaluations of the 1930s that had destabilized international trade. In the current imperfect world, governments in sub-Saharan countries have little choice but to pursue an exchange rate policy that fundamentally represents a regime of under-cutting its regional neighbours, who export many of the same commodities. In the long term this fallacy of composition problem may be reduced by export diversification.<sup>19</sup> In the short and medium term one must frankly concede the likelihood of fallacy of composition effects from any exchange rate policy, even one that is part of a pro-poor macro policy.

### 3.4 The Key: Fiscal Space

While not quite as futile as shifting the deck chairs on the Titanic in preparation for sinking, expenditure reallocation within a given budget alone is not a serious approach to poverty reduction. On the contrary, the most important constraint on a pro-poor macro policy is the expenditure constraint. To consider this, we define 'fiscal space' as the potential for expenditure expansion consistent with macro stability. The creation of fiscal space is the essence of a pro-poor framework, and all other macro policies derive from it. There are four ways to generate fiscal space: raising the revenue share in GDP; increasing the fiscal deficit; benefiting from debt relief; and receiving a higher level of development assistance. Each of these is considered below, from a pro-poor perspective.

Increasing the share of public revenue in GDP is the most effective way to create fiscal space, especially when combined with a prudent deficit. Increasing revenue has the potential to be pro-poor both on the revenue and expenditure sides, the former

through progressive taxation and the latter through social programmes and public investment. Raising tax rates and extending coverage are the obvious methods for increasing revenue. However, there is limited scope to do either of these in sub-Saharan countries. Because the vast majority of the labour force is not in wage employment, collecting income taxes is difficult to the point of impossible, and is restricted to the so-called formal sector. In some of the countries there may be scope for increasing taxation from companies. Substantial revenue gains may be possible by reducing tax ‘holidays’ and other *ad hoc* exemptions.

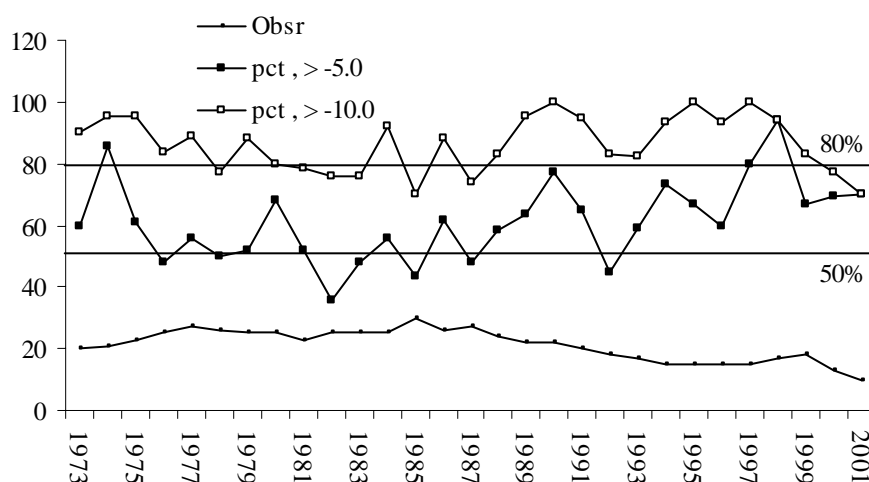
The potential for broadening the coverage of sales taxes is also limited, because a large portion of sales in rural and urban areas are by small and micro operators. Assessing the level of turnover of these operators involves the same problems as estimating incomes. Thus, it is not surprising that the bulk of public revenue arises from taxes on external trade, which as a result of trade liberalization has declined. The attempt to replace these by so-called value added taxes has not in general proved successful, in the sub-Saharan countries or elsewhere (Roy & Weeks 2004). The collection of VAT suffers from the same problems as for sales taxes in general. Given that tax systems in sub-Saharan countries are not progressive for reasons explained above, raising the tax share in GDP may be necessary, but is not a pro-poor way to create fiscal space.

For forty years, economists in developed countries viewed deficit spending as a mainstream policy, requiring no special justification. Indeed, it was balanced budgets that required defending, since they were pro-cyclical and seen to have no virtue in and of themselves. Some felt it necessary to qualify their support with the caveat that the budget should be balanced ‘over the cycle’ (for example, Gardner Ackley). Others rejected even this, maintaining that it was bad economics to fund investment from current income; governments, like businesses, should borrow to invest. For developing countries, it was argued that structural factors, such as supply inelasticity in agriculture and imports constraints, tended to limit the real value of the government expenditure multiplier, causing deficits to have an inflationary impact. This implied that counter-cyclical use of fiscal policy would not be effective, but did not affect the argument that investments could be funded by borrowing.

In the 1980s, a different mainstream orthodoxy emerged, harking back to the pre-Keynesian 1920s, that deficits, whether inflationary or not, were undesirable. As for other policy conclusions of the current orthodoxy, this one is based on a price-determined analysis. If an economy is price determined, there can be no real output increase resulting from demand stimulation. Therefore, the excess demand created by an increase in the fiscal deficit is eliminated either through the reduction in other categories of expenditure (‘crowding out’), an increase in net imports, or inflation. As a theoretical proposition, this argument is of limited interest. Since by definition real output effects of demand expansion are zero in a price determined system, the theory assumes its conclusions. The practical question is, does it appear that in sub-Saharan countries deficits stimulate the negative effects that the orthodoxy predicts? Below we argue that governments should be pragmatic about monetizing deficits. Therefore, it is important to provide an analytical basis for the proposition that monetization does not necessarily provoke a destabilizing rate of inflation, or an unmanageable trade balance.

It is beyond the scope of this draft of the paper formally to model deficit effects (see Weeks 2001 where this is done), so the discussion takes an *ad hoc* approach. First, it was shown in Section III that inflation rates have been low to moderate in most sub-Saharan countries. In the hyper-inflation countries, Angola and Congo DR, large deficits and high inflation went together, but they were the result of a common cause, persistent internal conflict. Second, the limited cross country information available suggests that fiscal deficits have not been excessive in most sub-Saharan countries. Using statistics from *World Development Indicators 2003*, Figure 3.6 shows the cross country statistics for the overall fiscal deficit including external grants; that is, current and capital expenditure on the debit side, and revenue and development assistance on the credit side. Because of the ‘patchiness’ of the coverage, if only countries with near-continuous statistics were included, it would have resulted in fewer than ten observations. Therefore, all countries with a statistic for a given year are included, and less exact indicators are used, the proportion of countries with deficits from zero to minus five percent of GDP, and zero to minus ten percent. The number of observations for each year is also shown, with the country details below the chart.

Figure 3.6:  
Fiscal Deficits as Share of GDP, in Sub-Saharan Countries:  
Percentage of Countries in Ranges, 1973-2001



Source: *WDI 2003*. Variable is ‘current and capital revenue and official grants received, less total expenditure and lending minus repayments. Data are shown for central government only.’

Notes: ‘Obsr’ is the number of countries, ‘pct’ is percent of countries, and ‘>’ is greater than (the deficit is negative, so  $-4 > -5$ ).

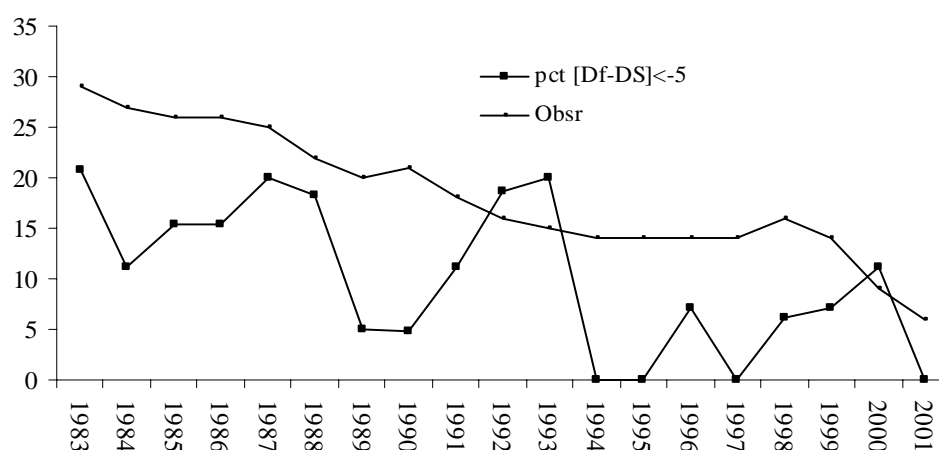
Countries (number of years with data in parenthesis): Botswana (24), Burkina Faso (21), Burundi (23), Cameroon (23), Chad (10), Comoros (6), Congo DR (29), Rep Congo (14), Cote d’Ivoire (17), Ethiopia (14), Gabon (16), the Gambia (11), Ghana (21), Guinea-Bissau (7), Kenya (29), Lesotho (22), Liberia (15), Madagascar (17), Malawi (18), Mali (13), Mauritania (6), Mauritius (25), Namibia (16), Niger (6), Nigeria (10), Rwanda (16), Senegal (17), Seychelles (16), Sierra Leone (26), Somalia (6), South Africa (29), Swaziland (21), Togo (11), Uganda (18), Zambia (16), Zimbabwe (22).

It can be noted that in twenty-one of the twenty-eight years, over eighty percent of countries had deficits less than minus ten percent, and in twenty-two of the years fifty percent ran deficits less than five percent. While it is difficult to judge appropriate deficit levels without reference to the economic circumstances of a country, one can conclude that available statistics suggest that perhaps half of the countries of the

region for three decades had levels that would allow for a prudent increase to generate fiscal space. Given the limited policy options of governments of the sub-Sahara, if inflationary pressures are low, monetization is probably the least anti-poor method of financing deficits. As discussed above, bond sales redistribute public revenue from the population as a whole to the wealthy.

Lenders have it in their power and discretion to increase fiscal space dramatically through debt relief. It is to the credit of several bilateral lenders that they have cancelled debts completely. Much more important in the sub-Saharan region are the debts owed to the IMF and the World Bank. Relief for these debts has proceeded at a pre-global warming glacial pace due to onerous conditionalities.<sup>20</sup> Figure 3.7 uses the fiscal deficit minus official debt service as the indicator for the impact of an accelerated multilateral debt relief process. As was the case for Figure 3.6, there are few countries with continuous statistics. Again, the percentage of countries is used as the indicator. Servicing official debt of the government requires a domestic currency entry in the fiscal budget, equal to the foreign currency debt payments converted at the official exchange rate. Therefore, the variable, the fiscal deficit net of debt service (DnDS), indicates the fiscal space that would be created by full debt relief. In only one of the nineteen years, the first 1983, did more than twenty percent of countries covered have a deficit net of debt service more than five percent of GDP. To put it positively, in almost all years, well over eighty percent of countries had a deficit net of debt service less than five percent. At strict comparison can not be made between Figures 3.6 and 3.7, because coverage of countries and years is different. However, at the very least Figure 3.7 suggests that substantial external debt relief would substantially liberate fiscal space.

Figure 3.7:  
Fiscal Deficit minus Debt Service as Share of GDP, Percentage of  
Countries, 1983-2001



Source: *WDI 2003*. Variable is 'the sum of principal repayments and interest actually paid in foreign currency, goods, or services on long-term debt, interest paid on short-term debt, and repayments (repurchases and charges) to the IMF [as portion of gross national income]'.

Notes: 'Obsr' is the number of countries; Pct [Df-DS]< -5 = percentage of countries whose ratio of (fiscal deficit minus debt service payments)/(Gross National Income) is greater than minus five percent (the deficit is negative, so  $-4 > -5$ ).

Countries (number of years with data in parenthesis): Botswana (14), Burkina Faso (10), Burundi (16), Cameroon (15), Chad (9), Comoros (5), Congo DR (19), Rep

Congo (11), Cote d'Ivoire (16), Ethiopia (13), Gabon (6), the Gambia (2), Ghana (11), Guinea-Bissau (7), Kenya (16), Lesotho (13), Liberia (6), Madagascar (17), Malawi (8), Mali (6), Mauritania (1), Mauritius (19), Nigeria (4), Rwanda (7), Senegal (8), Seychelles (16), Sierra Leone (17), South Africa (8), Sudan (2), Swaziland (12), Togo (5), Uganda (5), Zambia (6), Zimbabwe (15).

Figure 3.7 shows that multilateral debt relief is all the more appropriate, because fiscal constraints in the region are in part the direct result of multilateral lending that created no income generating asset. Whatever other problems may have been associated with adjustment and stabilization problems, they violated the basic rule of prudent budgeting, that borrowing should not be for the purpose of current expenditure.

The final source of fiscal space, additional development assistance, has been plagued with controversy and inconsistency on the part of the international development agencies. On the one hand, the development community has pledged itself to provide increased assistance (MDG 8). On the other hand, most agencies, bilateral and multilateral present arguments against doing this in practice. The most ubiquitous argument, which has replaced the earlier 'absorptive capacity', is that development assistance (and public expenditure in general) is determined by rent-seeking in the recipient countries; that is, corruption, including theft.

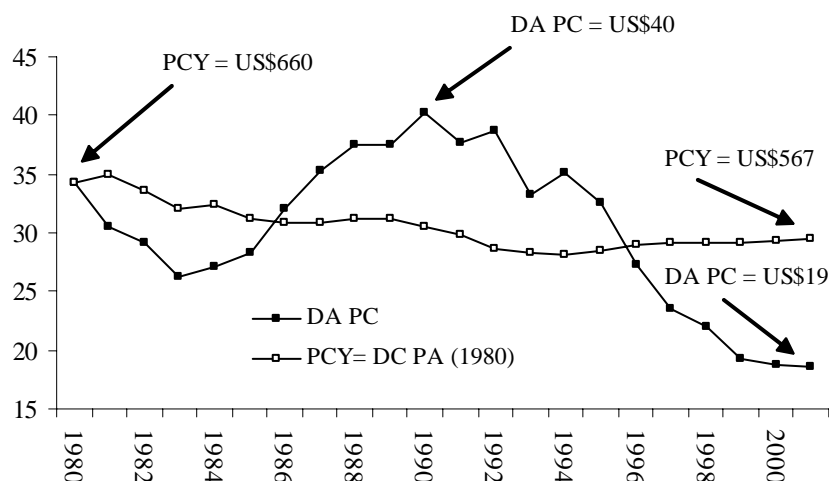
Several considerations undermine the force of this argument against increasing development assistance. First, it provides donors and lenders with a convenient explanation when development assistance is judged to be unsuccessful. Second, the governments of the developed countries committed themselves politically to MDG 8, which calls for major increase in development assistance. One presumes this commitment referred to the disbursement of that assistance, as well as its budgeting. To make the commitment for developing countries in general, then, to postpone its disbursement in specific cases suggests that either the commitment had a strong rhetorical component, or donors or lenders were unaware of country circumstances. Neither would release development agencies from the commitment they made.

Second, for at least a decade bilateral and multilateral agencies have funded projects for improving 'governance', a broad category that includes reducing corruption. The continuation of these projects by the same agencies suggests that some success has been achieved, since it would not be in an agency's interest to fund failure repeatedly. Therefore, the amount of corruption must have declined in many countries of the sub-Saharan.

The actual performance by donors and lenders in the sub-Saharan region has not been consistent with the commitment to poverty reduction and achieving the MDGs,<sup>21</sup> as shown in Figure 3.8. In the chart, development assistance per capita (DA PC) has been deflated by the price index for US GDP. For presentational purposes, regional income per capita (PCY) set equal to the development assistance per capita for the initial year (with actual levels indicated with arrows). After reaching a per capita high of forty US dollars in 1990, price deflated development assistance declined to less than half of that level, nineteen dollars per capita in 2001. Over the same period, per capita income for the region declined by about five percent.

Figure 3.8:

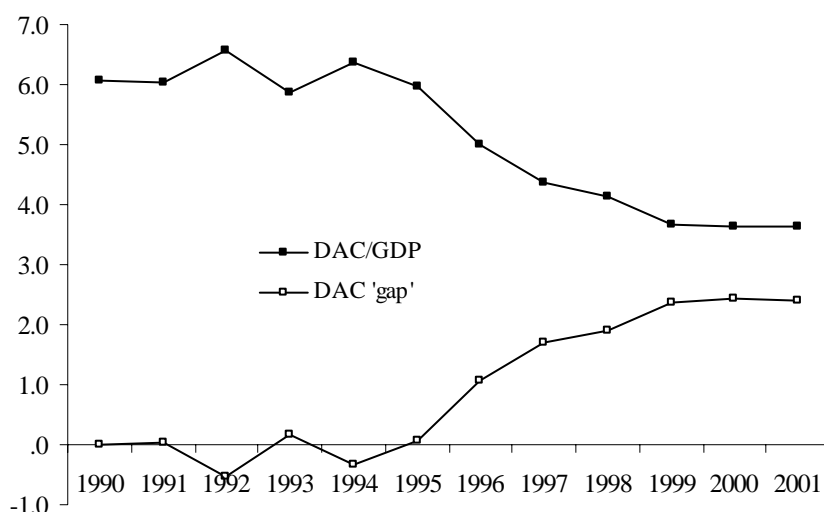
Constant Price Development Assistance per Capita & Per Capita Income (indexed), Sub-Saharan Countries, 1980-2001



Had development assistance to the region remained steady at its per capita level of 1990, in 2001 its share of an unchanged regional GDP would have been 2.4 percentage points higher than the actual level.<sup>22</sup> This is shown in Figure 3.9, and it should be stressed that this higher share in GDP would result not from an increase on the development assistance level of 1990, *only from no reduction in that level*. A return to the relative generosity of 1990 would substantially increase fiscal space.

Figure 3.9:

Development Assistance as % of GDP and the DA 'Gap',\* 1990-2001



\*The DAP 'Gap' is the share of development assistance in GDP in 1990 minus that for each subsequent year.

Having discussed the four routes to greater fiscal space, we can now summarize the potential for increasing it. The difficulties to raise revenue dictate modest potential for this method, perhaps one percent of GDP. While deficits in most countries are not

excessive, increasing them on average across countries should probably be avoided, though this could be done in countries with deficits below five percent. Average debt service across countries was 4.5 percent of GDP in 2001. If debt relief reduced this by half, hardly a radical proposal, 2.3 percentage points could be gained for fiscal space. Finally, a return to the assistance levels of 1990 would add another 2.4 percentage points. To prevent development assistance generating a new debt burden, it would be all provided as grants, or the concession loan component given a grace period until after the MDG deadline.

Thus, a small increase in public revenue, no increase in fiscal deficits, incomplete debt relief, and reversing the reductions in real development assistance would create the potential to expand fiscal space by almost six percentage points of GDP. *This would be sufficient to achieve the MDGs by 2015 in most countries.* Because of administrative capacity constraints and the time needed to design effective programmes, it would be necessary to phase such an increase over several years. The resulting share of government expenditure in GDP would not be excessive, around twenty-five percent on average for the region. These calculations show that the problem of finding the resources, fiscal space, to achieve the MDGs is not primarily technical. The primary difficulty is political will of the governments of the development assistance agencies, who formally committed themselves to the MDGs.

This increase in fiscal space and its effective application for pro-poor growth would require a macro framework described earlier in this: growth-fostering public expenditure based on public investment, a monetary policy that accommodates that expenditure, and a purposeful exchange rate policy to promote exports.<sup>23</sup>

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<sup>1</sup> See the World Bank website (<http://www.worldbank.org/poverty/strategies/index.htm>), where the PRSP process is described.

<sup>2</sup> For example, an agreement was signed between the UK Department of International Development (DFID) and the government of Rwanda establishing a medium term commitment by DFID and scheduling of assistance flows (see DFID 1999).

<sup>3</sup> In the approach of the international financial agencies, nominal exchange rate fluctuations are viewed as a buffer to external shocks. A recent study concludes, ‘the big selling points of floating exchange rates – monetary independence and accommodation of terms of trade shocks – have not lived up to their promise’ (Frankel 2003).

<sup>4</sup> A falling price level cannot in itself bring the economy to full employment even in a Neoclassical model. Since incomes in a market economy derive from prices, a falling price level in itself results in a downward spiral of incomes and prices. To resolve this problem and maintain the argument that a competitive economy continuously seeks full employment equilibrium, in the 1930s Pigou introduced the ‘real balance effect’. He argued that falling prices increase the purchasing power of money, which would lower the saving rate and raise demand to clear the goods market at a full employment level. However, the real balance effect requires that money be an asset but not a liability. If it is also a liability, then a fall in prices has no wealth effect, with the increase in the value of the asset exactly offset by the increase in the value of the liability. Since most money in a market economy is bank money, the real balance effect would be small even in theory. The same argument applies to all other forms of wealth-holding (see Weeks 1981, chapter 4).

<sup>5</sup> From a cross-country econometric study, Bruno and Easterly conclude, ‘Our findings do not support the view that reduction of high inflation carries heavy short-to-medium run output costs’ (Bruno & Easterly 1995).

<sup>6</sup> See Weeks (2001) and Geda (2002) for further discussion of counter-cyclical policies in the African context.

<sup>7</sup> For example, in Mozambique the World Bank deposits its loans directly into government accounts in private banks, and the latter are free to convert the foreign exchange when they wish.

<sup>8</sup> The crowding out phenomenon applies to all expenditure, but here we consider only the case of investment.

<sup>9</sup> For a more detailed discussion, see Saad Filho (2005).

<sup>10</sup> The calculation is from *World Development Indicators*, ‘Terms of Trade Adjustment’, and the average is of the absolute value, which reduces the standard deviation by half.

<sup>11</sup> These are the countries with data for all years.

<sup>12</sup> The distribution of inflation rates were as follows (low inflation countries first, high second, with the number of annual observations 570 and 152, respectively): percentage of years greater than ten percent

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(thirty-four and eighty percent); greater than twenty percent (eleven and seventy); and, greater than thirty percent (five and fifty-six). Twenty-nine of the sixty-two values over twenty percent for the low inflation countries occurred in Malawi, Nigeria and Zimbabwe, but these averages were not significantly different from those of the other twenty-seven countries in the group.

<sup>13</sup> In Ethiopia the proportion of the population with little or no use of money was estimated in the early 2000s to be over fifty percent (Geda, Shimeles & Weeks 2004).

<sup>14</sup> While the term 'informal' is almost invariably used to refer to all borrowing and lending activities outside the commercial financial system, it is a misnomer, because these activities are quite formalized in terms of behaviour. More accurate would be the dichotomy 'regulated' and 'unregulated'.

<sup>15</sup> Needless to say, this commitment was rarely kept, since it involved inviting currency speculation.

<sup>16</sup> It would be more precise to say that orthodox theory concludes that a floating regime would produce a nominal exchange rate that continually adjusted to the optimum for the relative price of tradables and non-tradables.

<sup>17</sup> Examples are white maize as opposed to yellow maize, and *teff*, the grain staple in Ethiopia.

<sup>18</sup> World trade grew at seven percent per annum, 1983-2001, according to *World Development Indicators 2003*.

<sup>19</sup> Fallacy of composition refers to the possibility that what seems true for one producer (a lower price increases sales) may not be true if all producers take the same measure.

<sup>20</sup> In their study of HIPC, Nissanke and Ferrarini conclude 'unless genuine debate can be extended to...policy conditionality – i.e. the design of [structural adjustment programmes] – real ownership of policy reform programmes will not be in the hands of recipient countries' (2004, 47).

<sup>21</sup> The MDGs were officially endorsed by heads of state in 2000 (the Millennium Declaration), though '[m]any of the targets of the MDGs were first set out by international conferences and summits held in the 1990s' (World Bank MDG website, [http://www.developmentgoals.org/About\\_the\\_goals.htm](http://www.developmentgoals.org/About_the_goals.htm)).

<sup>22</sup> Had the additional ODA been used effectively, GDP would have been larger, thus reducing the ratio.

<sup>23</sup> A similar macro programme is proposed by Bradford (2005).