Avoiding the stabilization trap: Towards a macroeconomic policy framework for growth, employment and poverty reduction

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Avoiding the stabilization trap: 
Towards a macroeconomic policy framework for growth, employment and poverty reduction

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I. I.
Preface

In the recent years, there has emerged a disenchantment over the so-called “Washington Consensus”, that has been the distinct guiding principle of the macroeconomic policy framework of the developing countries. The stabilization and structural adjustment programmes that constituted this framework are being seriously questioned, especially in respect of their impact on growth, employment generation and poverty alleviation.

This paper by Iyanatul Islam provides an analytical review and some empirical evidence to contend that macroeconomic policy, as currently understood and practiced in many countries, is mired in a ‘stabilization trap’. It seems to be preoccupied with stability at the expense of growth and with fiscal and inflation targets at the expense of employment.

The paper proceeds to argue that a careful scrutiny of global economic trends and the cross-country statistical analyses suggests that the empirical foundation of macroeconomic conservatism is fragile and that the intellectual momentum exists to develop a viable alternative to current orthodoxy. A return to the goal of employment and decent work provides an alternative long-term objective, which needs to be cast in a macroeconomic framework of sustained investment, and employment-friendly growth. This would entail: (a) an emphasis on employment creation, rather than the single-minded pursuit of fiscal and inflation targets, as a core policy goal; (b) developing a fair, efficient, transparent and accountable fiscal policy to cope with fluctuations in economic activity and to create the necessary ‘fiscal space’ for sustaining investments in human development and basic infrastructure; (c) comprehensive, rather than selective, social protection to deal with economic insecurity and to sustain effective demand by reducing the incidence of ‘under-consumption’; (d) empowering labour market institutions rather than entrenching labour market flexibility; (e) shifting the emphasis away from a technocratic approach to policy-making by encouraging a more inclusive approach entailing democratic deliberations; (f) tempering the influence of global investors on macroeconomic policy-making at the national level by adopting a circumspect approach to capital mobility; (g) creating an enabling international environment to complement pro-poor, employment-friendly macroeconomic policy agenda at the national level. It may be noted that these elements bear a strong affinity to the ILO’s Decent Work strategy.

The ILO’s Employment Strategy Department, through its programme on macroeconomic and development policy, encourages research to support the design of a macroeconomic policy framework that incorporates employment at the central objective. The views expressed in the current paper, however, are solely the author’s, and do not necessarily reflect those of the ILO.

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Contents

1. Introduction...........................................................................................................................................1

2. Setting the context: macroeconomic orthodoxy and its discontents .................................................2

   From the Keynesian compact to macroeconomic conservatism.........................................................2

   Macroeconomic policy and the interests of global investors............................................................3

3. Setting the context: macroeconomic orthodoxy and recent global economic trends..............5

4. Macroeconomic policy, growth and poverty: Revisiting the cross-country statistical analyses ..........................................................11

5. Seeking alternatives: towards pro-growth, pro-poor, employment-friendly macroeconomic policy ..........................................................16

   More of the same ?..................................................................................................................................16

   The case of unemployment benefits..................................................................................................22

   The case of public works.....................................................................................................................24

Bibliography .............................................................................................................................................33

Tables and figures

Fig. 1, Growth slow-down, countries by income level, 1960-79 vs 1980-00................................................6

Fig. 2, Growth slow-down, by region, 1960-79 vs 1980-00 ..................................................................6

Fig. 3, Decade of reforms in Latin America, 1985-1995.......................................................................8

Fig. 4, Changes in poverty, Latin America, 1980-96..............................................................................8

Fig. 5, Changes in inequality, Latin America, 1980-96 .......................................................................9

Fig. 6, Former Soviet Union and E.Europe, Real GDP in 2000 vs Real GDP in 1990............................10

Fig. 7, Rising inequality, Former Soviet Union and E.Europe ...............................................................10

Fig. 8, Distribution of countries by inflation rates, 1960-2000..............................................................12

Fig. 9, Distribution of countries by budget deficit, 1960-2000.............................................................13

Fig. 10, Inflation and per capita growth rate, 1960-2000......................................................................13

Fig. 11, Budget deficits and median growth of per capita GDP, 1960-2000............................................14

Table 1: Trends in global poverty by region, 1990-1999, the number of people living on less than US$1 a day ... 7

Table 2: Magnitude and persistence of recession, former Soviet Union and Eastern Europe...........9

Table 3: Inflation, budget deficit and growth, 1960-2000.......................................................................14

Table 4: Investment and growth, cross-country patterns, 1960-2000..................................................15

Table 5: Poverty and macroeconomic policy variables, some cross-country regressions.....................16
1. Introduction

Macroeconomic policy, as currently understood and practiced in many countries, is mired in a ‘stabilization trap’. It seems to be preoccupied with stability at the expense of growth and with fiscal and inflation targets at the expense of employment. The influence of global investors on policy-makers reinforces this bias in favour of fiscal and financial variables, at least in the context of developing economies. Orthodox macroeconomics also preaches the virtue of labour market flexibility rather than the importance of labour market institutions in dealing with the issue of the welfare of workers.\(^1\)

The paper proceeds to develop the core issues delineated above by setting the intellectual and empirical context in which current macroeconomic policy-making has moved away from its Keynesian roots to a distinct neoliberal and conservative agenda, an agenda that reached its zenith in the so-called ‘Washington Consensus’ embraced by the Bretton Woods institutions in the 1980s and 1990s. A careful scrutiny of global economic trends and the cross-country statistical analyses suggests that the empirical foundation of macroeconomic conservatism is fragile and that the intellectual momentum exists to develop a viable alternative to current orthodoxy. This would entail:

- An emphasis on employment creation, rather than the single-minded pursuit of fiscal and inflation targets, as a core policy goal;
- developing a fair, efficient, transparent and accountable fiscal policy to cope with fluctuations in economic activity and to create the necessary ‘fiscal space’ for sustaining investments in human development and basic infrastructure;
- comprehensive, rather than selective, social protection to deal with economic insecurity and to sustain effective demand by reducing the incidence of ‘under-consumption’;
- empowering labour market institutions rather than entrenching labour market flexibility
- shifting the emphasis away from a technocratic approach to policy-making by encouraging a more inclusive approach entailing democratic deliberations;
- tempering the influence of global investors on macroeconomic policy-making at the national level by adopting a circumspect approach to capital mobility;
- creating an enabling international environment to complement pro-poor, employment-friendly macroeconomic policy agenda at the national level.

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1 The ILO appears to be a natural candidate to act as the vanguard of an alternative macroeconomic framework for developing countries that would be clearly aligned with the objectives of sustainable and equitable growth, employment creation and poverty reduction. See ILO (1999a), ILO (2001)
2. Setting the context:
Macroeconomic orthodoxy and its discontents

From the Keynesian compact to macroeconomic conservatism

In an important contribution, the noted economist Paul Krugman observes that post-war democracies in the developed world once readily subscribed to the ‘Keynesian compact’. It was widely accepted that it was a fundamental obligation of governments to sustain full employment by seeking to minimise fluctuations in economic activity. In other words, governments can, and ought to, use countercyclical policy instruments to curb recessions and inflationary episodes. It grew out, as Krugman maintains, of the terrible experiences of the Great Depression. Governments in the industrialised world assimilated the quintessential Keynesian knowledge that it is possible to fight economic slumps rather than rely on the fatalistic idea that markets will eventually find a way to cure recessions.

The notion of sustaining full employment as the core of macroeconomic policy became unfashionable with the onset of world-wide inflation in the 1970s, the external debt crises that swept Latin America in the 1980s and the ascendency of conservative governments in the United States and the United Kingdom. Macroeconomics took on a distinct neoliberal hue as monetarist ideas – and more radical variants such as the rational expectations/real business cycle literature – gained intellectual ascendency in the cloistered confines of academia and spread to the corridors of central banks and finance ministries in the G7 nations. Over time, the single-minded pursuit of low inflation – or inflation targeting – by independent central banks and the maintenance of fiscal prudence by conservative finance ministries became the pillars of sound macroeconomic policy.

It became fashionable to argue that governments could only influence the inflation rate but market forces reflecting the preferences and expectations of profit-maximizing and utility-maximizing economic agents (employers and workers) ultimately determined the so-called ‘natural’ unemployment rate. In the absence of government intervention, a market economy would gravitate towards the full-employment equilibrium. The significant presence and persistence of unemployment reflected a combination of voluntary withdrawal of labour services and entrenched institutional distortions (such as strong unionism and assertive ‘social’ regulations pertaining to working conditions) that did not allow supply and demand to be balanced in the labour market. A natural implication of this world-view is that the maintenance of full employment belongs to the domain of microeconomic policy, rather than macroeconomic policy. The primary objective of the former is to encourage labour market

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2 Krugman (1999).
3 One must draw attention here to ILO’s Convention No. 122 pertaining to full employment.
4 This literature is often subsumed under the broad label of ‘new classical’ macroeconomics. See Miller and VanHoose (2001) for a standard textbook treatment of this genre of macroeconomic analysis.
5 As Vines (2001: 136) puts it: ‘In macroeconomics…there have been …major paradigm shifts in the past 50 years. These paradigms can be described as the fiscalist demand-management views of the 1950s and 1960s, the monetarism of the 1970s and 1980s and now the central bank inflation-targeting of the 1990s’.
6 In more technical terms, this translates to the view that the long-run aggregate supply curve is vertical, or equivalently, the long-run Phillips curve is vertical. It will shift in response to such forces as technical progress, capital accumulation and changes in the preferences and expectations of workers, but cannot be sustainably influenced by aggregate demand management policies.
flexibility as part of an overall framework that seeks to limit the state’s role in a market economy through a combination of privatisation, deregulation and liberalisation.\(^7\)

As these essentially conservative macroeconomic ideas spread to the developing world through the conduit of the Bretton Woods institutions, they became entrenched in the ‘Washington Consensus’ of the 1980s. Indeed, as John Williamson, the architect of the evocative epithet suggested, fiscal prudence should be ranked first in a list of ten propositions of good policy management that were shared by the Washington-based Bretton Woods institutions and the US Treasury.\(^8\) He was not alone in making this point. Arnold Harberger, a distinguished practitioner of development economics, developed thirteen ‘rules for good economic policy management’.\(^9\) Starting with the view that good technocrats are needed for economic policy – hence making this complex and inherently political enterprise purely a technical subject – he assigned top priority to inflation and budgetary control. There was no reference to employment creation and poverty reduction. Such prominent macroeconomists as Rudi Dornbusch and Stanley Fischer, also defined the domain of macroeconomic policy exclusively in fiscal and financial terms.\(^10\) Of course, these variables were seen as means to an end, namely, attainment of sustainable national prosperity, but the original Keynesian goal of full employment was no longer inducted as part of formal policy priorities.

**Macroeconomic policy and the interests of global investors**

There is another important way in which macroeconomic policy appears to have fallen into a stabilization trap, particularly in developing economies. The composition of external finance flowing into the developing world changed under the relentless pace of globalization of finance. Foreign aid and external assistance through bilateral and multilateral aid agencies dwindled in significance, while private short-term capital flows, aided by domestic financial liberalisation measures in the 1980s and 1990s in a range of middle-income economies, became ever more important.\(^11\) Over time, the purveyors of short-term capital flows began to cast a major influence on the evolution of macroeconomic policy at the national level. As local financial institutions and domestic corporations in developing economies with open capital accounts began to pile up liabilities in foreign currencies (although in many cases their revenues were generated in local currencies), macroeconomic policy progressively became hostage to the interests of global investors.

This ‘hostage’ phenomenon has several adverse implications. First, global investors display a distinct preference for low inflation and fiscal discipline.\(^12\) Admittedly, it makes considerable sense to insist on them in cases of countries with a history of erratic and

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\(^7\) See Standing (1999) for a thorough discussion – and critique - of the different dimensions of labour market flexibility. See also van der Hoeven (2000) on an empirical critique of the role that labour markets play in macroeconomic orthodoxy as enshrined in the Washington Consensus.

\(^8\) Williamson (1999).


\(^10\) Dornbusch (1993:6) observes: ‘…The four main goals of macroeconomic policy are controlling inflation, maintaining a stable and competitive exchange rate, exercising fiscal prudence and operating efficient capital markets’. Stanley Fischer (1993:487 ) notes: ‘The basic indicators of macroeconomic policy are the inflation rate, the budget surplus or deficit and the black market exchange premium…In essence, the inflation rate serves as an indicator of the overall ability of the government to manage the economy’.

\(^11\) For upper middle-income countries (based on World Bank classification), median private capital flows increased from 9.1 per cent of GDP in the 1960s and 1970s to 12.3 per cent of GDP in the 1980s and 1990s. At the same time, median aid as a per cent of national income fell slightly from 1.4 per cent to 1.1 per cent over the same period. Calculated from World Development Indicators 2002.

\(^12\) As the ADB (1999:19) observes: ‘As the domestic capital market becomes integrated with international capital markets, domestic policy-makers become subject to scrutiny by global investors. The discipline that this scrutiny provides helps to discourage the pursuit of excessive monetary and fiscal expansion (which can quickly lead to reserve outflows and currency depreciations).’
irresponsible macropolicies. There may even be a case for implementing institutional arrangements, for example central bank independence and deficit-limitation legislation, in such circumstances. However, an unwavering commitment to an anti-inflation strategy can lead to perverse and asymmetric responses. Although macroeconomic conservatism can embolden governments to fight inflation, it can stifle their capacity to deal with recessions.

Second, the need to retain the confidence of international money markets may lead governments in developing countries to display a bias in favour of fixed exchange rates. This may be regarded as a means of assuring the domestic corporate and financial lobby that the servicing costs of foreign currency denominated liabilities will be protected. It is also a signal to international money markets that governments will not allow the domestic private sector to default on foreign debt, thus sustaining the capital flows. Unfortunately, such a ‘deal’ builds up contingent or unfunded liabilities, impairing the long-term fiscal position of governments even as the need to win investor confidence leads them in the direction of macroeconomic conservatism in the short run.

Third, a macropolicy framework geared towards global investors entails the need to maintain large reserves in the form of relatively liquid assets, such as low-interest bearing US Treasury bills, in order to cope with the risk of capital outflows. There is, of course, an opportunity cost of maintaining large reserves as these funds could have been invested in more productive, job-creating activities. Some estimates suggest that the cumulative opportunity cost of holding large reserves in safe, low-return, liquid assets could range between 10 and 20 per cent of GDP for developing economies.

Fourth, the primacy of maintaining investor confidence exposes governments to the problem of the ‘impossible trinity’ in macroeconomic management. Policy-makers face the difficulty of simultaneously managing a fixed exchange rate, an open capital account and policy independence. Governments can at most retain two objectives. Events following the East Asian crisis have shown that governments gave up – or were forced to give up - policy independence to defend the fixed exchange rate regime and open capital accounts. Governments forfeited the ability to fight an incipient recession through expansionary demand management policies. In the initial stages of the crisis, the policy preoccupation became – with the support and exhortation of the Washington-led international community – to win the ‘confidence game’ at all costs. Thus, interest rates were raised and budgets were tightened. A prospective recession became a stark reality.

Finally, when developing economies gear their entire macroeconomic policy framework to the preferences and sentiments of global investors, they may be forced to shun the voices and concerns of domestic constituencies pertaining to policy choices and the strategic directions that a nation ought to take. This inadvertently undermines democratic governance and may well cause the tensions between domestic stakeholders and foreign constituencies to become unmanageable.

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13 The concept of unfunded government liabilities – created by explicit and implicit government guarantees to finance possible defaults of private sector indebtedness – has become a major issue in the wake of the East Asian crisis. In 1997, contingent government liabilities for the crisis-affected economies were in the top decile of 46 developing and developed countries (see Polackova, 1999:4).


15 See Moreno and Glick (2001) on the notion of the ‘impossible trinity’

16 This was, of course, the much-maligned IMF strategy launched initially in Indonesia, Korea, and Thailand. The strategy was significantly modified after some time. Critics contend that the initial strategy worsened the recession in all countries. The IMF contends that the initial policy response called for a temporary increase in the interest rate to stabilize the currencies of the affected countries. The alternative of a low interest policy would have matters worse by causing a free-fall in the currencies of the affected countries and worsening the dollar-denominated debt of the corporate sector. The IMF also maintains that an initial tightening of fiscal policy would not have been recommended had it anticipated the severity of the economic downturn in the region (see Fischer, 1998).
3. Setting the context: 
Macroeconomic orthodoxy and recent global economic trends

An empirical evaluation of macroeconomic conservatism needs to commence with an appreciation of recent global economic trends and their implications. A number of points may be highlighted.

- Two senior officials from the Ministry of Finance in Japan have argued that the challenge is no longer the control of world-wide inflation, but the threat of a global deflation. They call for a coordinated global strategy of reflation by central bankers led by Japan, Europe and USA.\(^{17}\)

- Recent research shows that there has been a world-wide growth slow-down in the 1980s and 1990s vis-à-vis the 1960s and 1970s, despite some notable exceptions, such as China (see figures 1 and 2 below).

- Some studies maintain that growth slow-down in developing countries is closely linked to growth slow-down in the OECD, rather than a deterioration in the policy environment of the average developing country.\(^{18}\)

- When China is excluded from the estimates, the 1990s show an increase in the absolute number in poverty across the world (see table 1).

- An UNCTAD study paints a grim picture of persistent and rising poverty among the least developed countries.\(^{19}\)

- Serious concerns have been raised about the reliability of global statistics on poverty.\(^{20}\)

- Some studies maintain that global inequality has gone up in the 1980s and 1990s,\(^{21}\) although a lot depends on the particular dimension of global inequality that is being measured.\(^{22}\)

- A WIDER study shows that of 73 countries (representing 80 per cent of the world’s population) for which reliable data exists 48 show an increase in inequality since the 1950s.\(^{23}\)

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\(^{17}\) See *Financial Times*, 2 December, 2002.

\(^{18}\) See Easterly (2001)

\(^{19}\) UNCTAD (2002)


\(^{21}\) See Wade (2002a, 2002b) and Milanovic, Dowrick and Akmal (2003) suggest no discernible change in inequality, after correcting for ‘biases’ in current measurement of world distribution of income.

\(^{22}\) See Ghose (2001)

\(^{23}\) See Cornia and Court (2001).
Fig. 1, Growth slow-down, countries by income level, 1960-79 vs 1980-00

Sources and notes: Derived from World Development Indicators, 2002

Fig. 2, Growth slow-down, by region, 1960-79 vs 1980-00

Sources and notes: as in fig. 1. FSU/EE = Former Soviet Union and Eastern Europe; ME/Africa = Middle East and Africa.
Table 1: Trends in global poverty by region, 1990-1999, the number of people (in percentages and millions) living on less than US$1 a day

<table>
<thead>
<tr>
<th>Region</th>
<th>Share (%) 1990</th>
<th>Share (%) 1998</th>
<th>Number (millions) 1990</th>
<th>Number (millions) 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-Saharan Africa</td>
<td>47.7</td>
<td>46.7</td>
<td>242</td>
<td>300</td>
</tr>
<tr>
<td>East Asia and the Pacific</td>
<td>27.6</td>
<td>14.2</td>
<td>452</td>
<td>260</td>
</tr>
<tr>
<td>South Asia</td>
<td>44.0</td>
<td>36.9</td>
<td>495</td>
<td>490</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>16.8</td>
<td>15.1</td>
<td>74</td>
<td>77</td>
</tr>
<tr>
<td>Eastern Europe and Central Asia</td>
<td>1.6</td>
<td>3.6</td>
<td>7</td>
<td>17</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>2.4</td>
<td>2.3</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>29.0</td>
<td>22.7</td>
<td>1,276</td>
<td>1,151</td>
</tr>
<tr>
<td>Excluding China</td>
<td>28.1</td>
<td>24.5</td>
<td>916</td>
<td>936</td>
</tr>
</tbody>
</table>

Sources and notes: UNDP (2002:18) from World Bank data.

There are conspicuous cases of regions in distress that go against the prescriptions of orthodoxy. Thus:

- Latin America represents a case of ‘reforms without results’. Despite decades of reforms, poverty in Latin America today is higher than in 1980, real wages are barely equal to 1980 and inequality remains persistent and conspicuously high (see figures 3 to 5).

- The attempt at ‘big-bang’ privatisation and fast-tracking of capitalism in the transition economies of Eastern Europe and Former Soviet Union have led to rather disappointing outcomes. The ‘transition recessions’ have been longer and deeper than the Great Depression. GDP today (2000) is still below the 1990 level (by as much as 40 per cent) for many of these economies. Poverty and inequality have gone up sharply (see table 2 and figures 6 and 7).

- The 1997 financial crisis in East Asia has shown that even well managed and highly successful economies can become tragic victims of contagious macroeconomic shocks. Unlike the Latin American experience of the 1980s, such crises cannot be linked to irresponsible macropolicies. East Asian-style macroeconomic crises are significantly driven by the shifting moods and sentiments of global investors, even when so-called ‘fundamentals’ at the country-level are sound.

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Fig. 3. Decade of reforms in Latin America, 1985-1995

Index of overall policy reform (0.0 to 1.0), Latin America

Sources and notes: Derived from data provided in IDB (1997: 96)

Fig. 4. Changes in poverty, Latin America, 1980-96

Estimate 1 Estimate 2

1980 to 1996

Sources and notes: Derived from data provided in Equidad (2000:1).
Alternative estimates are based on different methods of measurement.
For further details, see original sources.
Fig. 5, Changes in inequality, Latin America, 1980-96

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimate 1</th>
<th>Estimate 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0.52</td>
<td>0.55</td>
</tr>
<tr>
<td>1990</td>
<td>0.55</td>
<td>0.54</td>
</tr>
<tr>
<td>1996</td>
<td>0.56</td>
<td>0.56</td>
</tr>
</tbody>
</table>

Sources and notes: as in figure 4

Table 2: Magnitude and persistence of recession, former Soviet Union and Eastern Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>Consecutive years of output decline</th>
<th>Cumulative output decline (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSB</td>
<td>3.8</td>
<td>22.6</td>
</tr>
<tr>
<td>CIS</td>
<td>6.5</td>
<td>50.5</td>
</tr>
</tbody>
</table>

Great Depression (1930-34)

<table>
<thead>
<tr>
<th>Country</th>
<th>Consecutive years of output decline</th>
<th>Cumulative output decline (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Germany</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>UK</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>USA</td>
<td>4</td>
<td>27</td>
</tr>
</tbody>
</table>

Sources and notes: adapted from World Bank (2002: 5)
Sources and notes: derived from data provided in World Bank (2002:5)

Sources and notes: as in figure 6
4. Macroeconomic policy, growth and poverty:
Revisiting the cross-country statistical analyses

Statistical analyses, entailing both descriptive methods and econometric techniques applied to large-scale cross-country data, have typically been employed by practitioners sympathetic to the cause of the ‘Washington Consensus’ to argue the case for macroeconomic conservatism. Stanley Fischer was one of the first to induct macropolicy variables in cross-country growth regressions and concluded that low inflation and fiscal prudence contributed to faster growth.27 Others, such as Ian Little et al, focused on studying in greater depth the economic history of a sample of developing countries and combined this with some regression analyses.28 Based on such work and subsequent contributions to the literature that extended the cross-country approach to a study of the statistical determinants of global poverty,29 one can arrive at surprisingly eclectic conclusions that are contrary to the tenets of macroeconomic orthodoxy. Thus:

• Macroeconomic conservatism implicitly focuses on ‘special cases’ because it is a story of the misfortunes that await countries if they engage in macroeconomic extremes.
• Moderate rates of inflation are not harmful to growth. Inflation rates need to be quite high (in the 15 to 40 per cent range) before they become prejudicial to growth.30
• Studies based on OECD data show that the incorporation of government expenditure in regression analysis leads to a positive relationship between inflation and long-run income suggesting that fiscal policy can outweigh the negative impact of inflation on growth.31
• Studies using OECD data also show that countries that adopted inflation targeting that aimed for very low rates of inflation (0-3 per cent) do not necessarily exhibit either lower inflation or lower unemployment than countries that did not adopt inflation targeting.32
• While some studies have demonstrated a statistical link between fiscal deficits and poor growth performance, others focusing on both poverty and growth have not been able to endorse them. More specifically, there is no statistical link between fiscal deficits and higher incidence of poverty.33
• Some studies have demonstrated that inflation has a negative impact on the living standards of the poor, but the estimated elasticities are quite low and can be easily offset by countervailing factors. For example, a 1 per cent increase in inflation leads to a 0.01 per cent decline in the average income of the poor, but a 1 per cent increase in per capita GDP leads to a 0.94 per cent increase in the average income of the poor.34

27 Fischer (1993). It is worth bearing in mind that, although the cross-country approach that such studies adopted were inspired by the seminal work of Robert Barro (1991) on growth regressions, the latter was not primarily concerned with demonstrating the virtues of prudent macroeconomic policies. Its intent was to test the empirical veracity of endogenous growth theory.
28 Little et al (1993)
29 These contributions have been made by both advocates and critics of the ‘Washington Consensus’. Examples include Ghura et al (2002), Cashin et al (2001), Mallick and Chowdhury (2002).
30 Bruno and Easterly (1995)
31 Mallick and Chowdhury (2002)
32 See, for example, Debelle et al (1998)
33 Dollar and Kray (2000)
34 Ghura et al (2002)
• While growth is a key determinant of poverty, it can be offset by rising inequality.\textsuperscript{35} Hence, what matters to poverty reduction is equitable growth rather than the single-minded pursuit of fiscal prudence or low inflation.

• Cross-country econometric estimates are sensitive to the nature of the data (in terms of variations in time-periods and sample size) raising doubts about their credibility as a source of policy advice. There is no alternative to in-depth studies of the experiences of specific countries or a specific set of countries.\textsuperscript{36}

Such eclectic conclusions are upheld by some new estimates presented in this paper. They are generated from long-run data (1960 to 2000) across a large set of countries provided in the World Bank’s World Development Indicators 2002.\textsuperscript{37}

To start with, consider figures 8 and 9 that show that high inflation rates and large fiscal deficits do not represent the norm for either developed or developing economies when seen from the perspective of long-run data. Admittedly, as figures 10 and 11 show, inflation in excess of 15 per cent or fiscal deficits in excess of 10 per cent of GDP are, for some periods at least (1980-2000), associated with negative growth but when these findings are seen in conjunction with figures 8 and 9, it seems that these outcomes represent macroeconomic extremes. For example, only a small number of countries are characterised by budget deficits in excess of 10 per cent of GDP (figure 9). The bulk of countries have budget deficits that range between 0 and 5 per cent of GDP.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{distribution}
\caption{Distribution of countries by inflation rates, 1960-2000}
\end{figure}

Sources and notes: as in figure 1

This is an important point because macroeconomic conservatism is essentially a parable on the misfortunes that await countries - thankfully not in the majority - when they allow inflation to become excessive and the fiscal position to become untenable. No one with any degree of professional credibility is going to argue against such a sensible proposition. Hence, current macroeconomic orthodoxy is an approach that relies on extreme examples to build its

\textsuperscript{35} Ghura et al (2002)
\textsuperscript{36} Cashin et al (2001)
\textsuperscript{37} A similar exercise has been conducted by Muqtada (2002).
case. The substantive disagreements and debates are likely to be about ‘intermediate cases’. This is where dogmatic prescriptions are unlikely to be helpful.

Fig. 9, Distribution of countries by budget deficit, 1960-2000

Fig. 10, Inflation and per capita growth rate, 1960-2000

Sources and notes: as in figure 1
Consider now table 3. Here, countries are grouped into ‘good performers’ (represented by per capita growth in excess of 3 per cent per annum), ‘intermediate performers’ (between 1 and 3 per cent per capita growth), and ‘bad performers’ (less than 1 per cent per capita growth). The inflation rate for the ‘intermediate performers’ is a little above the ‘good performers’ but there is no meaningful difference in the fiscal position of the two groups. As expected, the ‘bad performers’ are characterised by relatively high rates of inflation, but even here, the recorded fiscal deficit is not significantly worse than other groups.

The findings in table 3 suggest that one would expect to find a statistically significant negative relationship between inflation and growth, but not between fiscal deficits and growth. This can be inferred from the cross-country regression reported below. Note, however, that the estimated size of the coefficient for the inflation variable is quite small.
The cross-country regression also highlights the important point that investment matters for growth and can easily offset the negative impact of inflation on growth (given that the size of the estimated coefficient is significantly larger than the one for inflation). An important study by Ian Little et al maintains that macropolicy influences growth through the investment channel, and this may well be a more direct way of exploring the macropolicy-growth linkage than either the government’s fiscal position or a given inflation rate. Volatility in GDP impairs the investment climate by creating uncertainty and also leads to volatility in investment. Furthermore, countries with mediocre growth suffer from both low investment ratios as well as low productivity of investment, particularly because of poor project selection in the public sector and the uncertainty created by a volatile macroeconomic environment.

These propositions are illustrated in Table 4. Once again, countries are grouped into ‘good performers’ (growth in excess of 3 per cent per annum), ‘intermediate performers’ (growth between 1 and 3 per cent) and ‘bad performers’ (growth of less than 1 per cent). For the 1960-2000 period, the ‘bad performers’ had low investment ratios, high volatility of investment (as measured by the coefficient of variation) and negative productivity of investment (defined here as investment ratio adjusted by the growth rate) vis-à-vis the ‘good performers’.

Table 4: Investment and growth, cross-country patterns, 1960-2000

<table>
<thead>
<tr>
<th>Performers</th>
<th>Median Growth</th>
<th>Investment ratio</th>
<th>Investment productivity</th>
<th>Coeff of var. of investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>4</td>
<td>24.84</td>
<td>0.15</td>
<td>0.18</td>
</tr>
<tr>
<td>Intermediate</td>
<td>2.1</td>
<td>20.52</td>
<td>0.1</td>
<td>0.21</td>
</tr>
<tr>
<td>Bad</td>
<td>-0.18</td>
<td>19.86</td>
<td>-0.01</td>
<td>0.27</td>
</tr>
</tbody>
</table>

Sources and notes: as in figure 1. Countries classified into performance categories based on per capita growth rates (good = above 3 per cent; intermediate = between 1 and 3 per cent; bad = less 1 per cent)

Table 5 documents the statistical associations between poverty (based on international poverty lines), per capita income, inflation, budget deficits and inequality. No statistically significant link exists between poverty and inflation; nor does such a link exist between poverty and the government’s fiscal position. The key determinants of poverty are the level of per capita

38 In a classic contribution to cross-country growth regressions, Levine and Renelt (1992) highlighted the role of investment in explaining cross-country growth.

income, the rate of growth of per capita income and inequality– findings that are well-known in the literature and highlight the importance of equitable growth, rather than fiscal and nominal variables, in poverty reduction.

Table 5: Poverty and macroeconomic policy variables, some cross-country regressions

<table>
<thead>
<tr>
<th>Dependent variables</th>
<th>Adjusted R-square</th>
<th>No. of observations</th>
<th>Time period</th>
<th>Per capita Income (estimated coefficient with t-ratios in parentheses)</th>
<th>Per capita growth (estimated coefficient with t-ratios in parentheses)</th>
<th>Inequality (Gini coefficient) (estimated coefficient with t-ratios in parentheses)</th>
<th>Inflation (GDP deflator) (estimated coefficient with t-ratios in parentheses)</th>
<th>Budget deficit/surplus (% of GDP) (estimated coefficient with t-ratios in parentheses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty ($1-a-day)</td>
<td>0.14</td>
<td>60</td>
<td>1980s and 1990s</td>
<td>-3.98 (-3.32)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.01</td>
<td>60</td>
<td>1980s and 1990s</td>
<td></td>
<td>-0.02 (-.99)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.05</td>
<td>60</td>
<td>1980s and 1990s</td>
<td></td>
<td></td>
<td>-0.85 (-1.12)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>0.29</strong></td>
<td><strong>55</strong></td>
<td>1980s and 1990s</td>
<td><strong>-0.01</strong> (2.42)</td>
<td><strong>0.630</strong> (-4.71)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poverty ($2-a-day)</td>
<td>0.05</td>
<td>60</td>
<td>1980s and 1990s</td>
<td>-3.43 (-2.10)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.01</td>
<td>60</td>
<td>1980s and 1990s</td>
<td></td>
<td>-0.33 (-1.27)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.02</td>
<td>49</td>
<td>1980s and 1990s</td>
<td></td>
<td></td>
<td>-1.45 (-1.39)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>0.39</strong></td>
<td><strong>55</strong></td>
<td>1980s and 1990s</td>
<td><strong>-0.01</strong> (5.98)</td>
<td></td>
<td>0.17 (0.57)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources and notes: Estimates based on OLS method and applied to long-run data compiled from World Development Indicators 2002, UNDP 2002 (for global poverty) and WIDER inequality database. Statistically significant results highlighted in bold.

5. Seeking alternatives: Towards pro-growth, pro-poor, employment-friendly macroeconomic policy

More of the same ?

If, as argued, orthodox macroeconomics as applied to developing countries rests on fragile empirical foundations, what are the alternatives? To defenders of the faith, lack of robust evidence supporting macroeconomic orthodoxy does not necessarily mean that the key tenets of the basic model are wrong. It means instead that recalcitrant countries have not made a sufficiently resolute commitment to fiscal prudence and low inflation and that the complementary reform program of privatisation, deregulation and liberalisation as envisioned in the ‘Washington Consensus’ needs to work on a faster and deeper scale. Thus, for example, Rudi Dornbusch, in commenting on the ‘lost decades’ in Latin America urges deeper reforms.\(^{40}\) Indeed, even the Inter-American Development Bank (IDB) that played an important role in highlighting the disappointing outcomes of 10 years of a stabilization-cum-structural adjustment agenda in Latin America felt obliged to urge policy-makers in the region

\(^{40}\) Dornbusch (2000)
to persist with the reform program with even greater vigour and to deal with what it regards as entrenched labour market rigidities — and this, despite, falling real wages over a protracted period.\footnote{41}

In the specific case of Argentina, reeling from one of the deepest recessions in its history, there is a view that policy-makers have not been resolute enough in pursuing fiscal prudence.\footnote{42} Others have urged that the country should strengthen its international financial linkages through complementary reforms despite the fact that such linkages have severely constrained the discretionary capacity of policy-makers to respond to the current recession.\footnote{43} Yet others have called for complete integration with the US economy by dollarising the Argentine economy.\footnote{44}

It is unlikely that such a position will be greeted with sympathy in Latin America and elsewhere. The inception of a democratically elected left-wing government in Brazil for the first time in its electoral history has been interpreted by some observers as an indication of the rising dissent — and disappointment — with economic orthodoxy.\footnote{45} Aware of such discontents, and mindful of the unacceptably pervasive scale of global poverty and inequality, the Bretton Woods institutions have sought to offer their alternatives to the original version of the ‘Washington Consensus’. This is now enshrined in the ‘Poverty Reduction Strategy Papers’ (PRSP) that low-income developing countries have to produce. The PRSP is now seen as a formal instrument for enhanced access to development assistance. The Bretton Woods institutions are expected to play a leading role in this process.\footnote{46} These developments in turn reflect the fact that the global framework of development assistance is driven by a renewed commitment to poverty reduction. Thus, one has witnessed the enunciation of the ‘Millennium Development Goals’ (MDGs) at a UN summit in September 2000 where the international development community has made a formal declaration to bring about target reductions in both income and non-income dimensions of global poverty by 2015 (using 1990 as the base year). The MDGs have been re-affirmed in subsequent summits.

A fundamental principle of the PRSPs is that they should be nationally owned and driven and be produced on the basis of public consultations and participation. This is a tacit admission that, in the past, Washington Consensus-driven policies were seen as too technocratic and externally imposed. The notion of nationally owned and driven PRSPs is also a realisation that a standardised policy framework of macroeconomic prudence, privatisation, deregulation and liberalisation was insufficiently sensitive to country-specific circumstances.

So far, about 70 PRSPs (50 interim papers and 20 final versions) have been produced and evaluated.\footnote{47} An ILO evaluation notes that the deficiency of the existing PRSPs lies in the fact that they either ignore or insufficiently reflect employment concerns in proposed policies for dealing with poverty. Furthermore, despite their participatory and consultative nature, the current cohort of PRSPs do not incorporate the views and concerns of trade unions and have

\footnotesize{\begin{quote}
\footnote{41} IDB (1997)
\footnote{43} Caballero (2000)
\footnote{44} Schuler (2002). Others, such as Rodrik (2002b), Weisbrod and Baker (2001) and Stiglitz (2002a), see the deep financial integration of the Argentine economy with the US economy as its problem rather than as its solution.
\footnote{45} Robert Samuelson writing in the Washington Post (October 16, 2002) observes: ‘Brazil’s presidential election represents a final unravelling of the so-called Washington Consensus…’
\footnote{46} The Bretton Woods institutions have aligned their lending programme with this new approach. The IMF has launched its Poverty Reduction Growth Facility (PRGF) that supersedes the Enhanced Structural Adjustment Facility (ESF). In the case of the World Bank, all its activities in low income countries is expected to be based on the PRSP which in turn builds on its Comprehensive Development Framework (CDF).
\footnote{47} See ILO (2002b), Ames et al (2002) and UNDP (2002)}
generally have not incorporated issues in industrial relations and the way they relate to a poverty reduction agenda.\textsuperscript{48}

From the perspective of this paper, the problem with the PRSPs is that a poverty reduction agenda is constrained to fit the requirements of the orthodox macroeconomic framework, although there is some indication that the Bretton Woods institutions are prepared to adopt a more flexible approach to short-term macroeconomic targets.\textsuperscript{49} Despite this, one evaluation by the IMF suggests that the some of the PRSPs were characterised by excessively optimistic macroeconomic projections that bore little resemblance to country-specific circumstances and constraints. Furthermore, in many countries, ‘…the PRSP process produced extensive lists of goals and an even longer lists of actions in support of those goals’. Thus the authors of the review note that ‘…trade-offs and prioritisations are clearly needed if the strategy is to be realistic’. At the same time, the authors concede that ‘…the PRSP countries often find it difficult to set priorities in the face of uncertainties regarding their overall growth strategy, the cost of various actions and their own budget constraints’. They also highlight the concerns of developing country governments that the ‘…procedures and reporting requirements associated with PRSP-lending operations remain overly demanding.’ Developing country representatives, both from the government and civil society, also ‘…pointed to continuing tensions between the principle of country ownership and the tendency of donors to promote issues of importance to themselves…’ The reviewers conclude that ‘…more information on aid commitments and more predictable aid flows would help low-income countries plan and implement their own strategies’.\textsuperscript{50}

It appears that the current generation of PRSPs run the risk of becoming undone by macroeconomic and financial constraints. There is a need to move beyond them and invest efforts in building a new consensus on an alternative macroeconomic framework that is driven by, rather than driving, employment creation and poverty reduction targets. Here is a sketch – based on the emerging literature – of the key elements of such a framework.\textsuperscript{51} One may note that these elements have a strong affinity to, and are consistent with, the Decent Work strategy of the ILO.

\section*{1. Employment creation, rather than the single-minded pursuit of fiscal and inflation targets, should be seen as a core macroeconomic policy goal}

Current orthodoxy emphasises inflation targeting, together with fiscal prudence, in determining the overall policy framework. For example, after the 1997 financial crisis, the IMF, through its Letter of Intent, reached an agreement with the Indonesian government, that an independent central bank (Bank Indonesia) should act exclusively as the guardian of price stability and aim for a medium-term inflation rate of 3 to 5 per cent, while the Finance Ministry would engage in ‘fiscal consolidation’ to cope with a crisis-induced explosion in public debt.\textsuperscript{52} The principle of inflation targeting driven by independent central banks has also been urged by the IMF for other crisis-affected Asian economies, such as Korea.\textsuperscript{53}

\textsuperscript{48} ILO (2002b).
\textsuperscript{49} This point is noted by Muqtada (2002) in his interpretation of the ‘sourcebook on PRSP’ prepared by the Bretton Woods Institutions.
\textsuperscript{50} Ames et al (2002:3-4).
\textsuperscript{51} Examples include the thesis of ‘socially responsible macroeconomics’ developed by Lustig (2000) and the advocacy of ‘pro-poor’ macroeconomics by the UNDP. Examples of the latter approach can be found in McKinley (2001).
\textsuperscript{52} The Indonesian government is committed to a balanced budget in 2003 (ILO, 2002c).
\textsuperscript{53} Stiglitz (2002b)
As noted at a previous juncture, the notion that very low inflation is an appropriate macroeconomic goal is not supported by the empirical literature. As noted too, in the OECD economies that pioneered inflation targeting, studies show that the outcomes have not been always superior to those attained by OECD economies that did not pursue inflation targeting. Furthermore, concerns have been expressed that independent central banks can become too inflation averse and that the setting of macroeconomic policy goals should be the prerogative of democratically elected governments rather than the preserve of non-elected technocratic agencies.

On the issue of fiscal prudence, the discussion on the pertinent empirical evidence has suggested the lack of a reliable statistical link between the government’s fiscal position and either growth or poverty. In any case, long-run data show that the majority of developing countries do not, or cannot afford to, run fiscal deficits in excess of 5 per cent of GDP. Hence, concerns about lack of fiscal prudence in the developing world may be exaggerated. Not surprisingly, given such caveats based on evidence and experience, the Nobel Laureate Joseph Stiglitz has drawn attention to the context-specific nature of budget deficits. As he puts it:

…there is no simple optimum level of the budget deficit. The optimum deficit - or the range of sustainable deficits - depends on circumstances, including the cyclical state of the economy, prospects for future growth, the uses of government spending, the depth of financial markets, and the levels of national savings and national investment.54

Given the relatively fragile nature of cross-country findings, it is best to be circumspect about making mechanical and formulaic statements that countries should aim for predetermined inflation and fiscal targets or to get overly concerned if these limits are crossed in some countries. This paves the way for arguing that integrating employment concerns in macroeconomic management is a much-needed task that will restore some balance in the way that policy-makers set goals and priorities. It would entail setting durable job creation targets that would, as a minimum, be consistent with absorbing new entrants to the work-force (given assumptions about the structural parameters of an economy). This key parameter would then set the context for working out the corresponding growth rate, requisite policy initiatives and the budgetary framework.

The use of employment creation targets as the locus of macroeconomic management in turn provides scope for exploring ways in which the growth process can be made employment-intensive thus reducing the burden on the growth rate alone to engender the required number of jobs to meet policy goals. Well-known initiatives include the encouragement of small and medium-sized enterprises (SMEs) to act as key vehicles for job-creation by ensuring the reduction of entry barriers to new and existing businesses, making the regulatory environment simple and predictable and ensuring that the education and training system supports the human resource needs of SMEs.

ILO studies have argued that there is another direct form of intervention that the government could exercise more assiduously that could influence the employment intensity of growth. This pertains to the proposal that the government ought to consistently incorporate the use of ‘labour-based’ rather than ‘equipment-based’ production methods in its public investment policy.55 The public sector in is a major player in infrastructure investment. One ILO study in the context of a specific country has shown that labour-based production methods in infrastructure investment can generate as many as 1.2 million durable jobs over

54 Stiglitz (1998:5)
55 ILO (2000a).
four years without compromising standards of quality that one associates with equipment-intensive production techniques.\textsuperscript{56}

A major challenge facing many developing countries is to find ways in which fiscal policy can be made less pro-cyclical in order to cushion the impact of adverse shocks. One could argue that governments in developing countries cannot easily respond to a slow-down with expansionary macroeconomic policy in the way that governments in developed countries can. There are a number of possible explanations. To start with, if initial conditions are such that public finances have been badly managed, so that budget deficits are large and international reserves have been whittled away, then a fiscal expansion may simply engender a fiscal crisis. Beyond this extreme example, there are legitimate concerns that the tax and economic structure in many developing countries are such that government revenues are pro-cyclical, falling sharply in a recession and rising during boom periods.\textsuperscript{57}

Given such constraints, how can one design counter-cyclical fiscal policy to create the necessary ‘fiscal space’ to sustain investments in human capital development and basic infrastructure? It should be possible to create a fiscal stabilization fund that would be used to smooth public spending across economic cycles.\textsuperscript{58} Such a fund would be financed from excess revenues collected by the central government during periods of growth, commodity price booms, privatisations and concessions by the international community (e.g. debt restructuring and debt relief).\textsuperscript{59}

The setting up of a stabilization fund is merely the beginning of a fair, efficient, transparent and accountable fiscal policy in developing countries. What principles should be promulgated to ensure that public spending programs are generally pro-growth and pro-poor and that such designated programs are protected during macroeconomic crises?

There is general agreement that ‘targeted human development programs’ (THDPs), and public investments in basic infrastructure are both pro-poor and pro-growth in orientation. Public expenditure on basic health and education may be complemented by institutional arrangements in which program benefits are utilised by the prospective beneficiaries for their designated purposes. For example, in order to access program benefits (in both cash and kind), poor families could be required to send their children to school, to undertake mandatory pre-natal/post-natal care as well as attend nutritional courses.

Apart from fiscal commitments to basic education and health, there is general agreement that public expenditure on basic infrastructure enhances growth and creates an enabling environment for poverty reduction by reinforcing the complementarity between

\textsuperscript{56} ILO (1999b), The study pertains to Indonesia.

\textsuperscript{57} Thus, if taxes are largely expenditure-based, as they often are, and if a developing economy relies heavily on primary commodities, then revenues would be pro-cyclical. It has been estimated that in Latin America a 1 per cent fall in growth leads to a decline in revenues of 5.8 per cent, while the corresponding number in industrialised countries is 1.8 per cent. (Lustig 2000:9)

\textsuperscript{58} It should be reiterated that developing countries currently hold international reserves in liquid foreign assets to cope with fluctuations in capital flows. See discussion in this paper. Less attention seems to have been given to holding public revenues in liquid foreign assets to cope with fluctuations in domestic economic activity.

\textsuperscript{59} Examples include the Chilean Copper Compensation Fund and the Peruvian legislation in December 1999 that incorporated the launching of a stabilization fund as part of its ‘Fiscal Prudence and Transparency Law’
The challenge, however, is to ensure that pro-growth and pro-poor public expenditure programs are protected and sustained during economic downturns. Studies have shown that when such programs are scaled down in response to a crisis, they lose their potency to reach the poor. A variety of budgetary protocols could be developed to reinforce the capacity of governments to protect pro-growth and pro-poor public spending. One possibility is earmarking revenues (say, from a previously created fiscal stabilization fund) for specific programs based on agreed criteria (such as the impact of effectiveness of programs in reaching the poor and in sustaining a pro-growth environment). The adoption of this procedure means that spending in the earmarked areas is quarantined from fiscal adjustments. Of course, the earmarking exercise has to be limited in scope and carried out in a transparent and accountable manner.

Another budgetary protocol worth examining is for the government and the legislature to negotiate, during the budget approval process, a ranking of programs in order of priority using agreed criteria (as noted above). Thus, when ‘...expenditure cuts are needed, the order in which cuts take place are determined automatically on the priority assigned to each program’.

Admittedly, budgetary protocols are not perfect and there is always the risk that they can be abused by vested interests or they can be significantly compromised through protracted political horse-trading. Nevertheless, they stand a better chance of leading to a fair, efficient, transparent and accountable fiscal policy for sustaining pro-growth, pro-poor public spending programs across economic cycles in contrast to a situation, sadly quite common, where formal arrangements are not in place. The process of fiscal adjustments then becomes mired in political controversy and conflict.

3. Provide comprehensive social protection to deal with economic insecurity and to sustain effective demand by reducing the incidence of ‘underconsumption’

The 1997 financial crisis in East Asia is perhaps the most recent and stark reminder that economic insecurity and vulnerability are endemic facts of life even in developing economies hailed in the past as success stories. The usual statistics that focus on current poverty underestimate the incidence of vulnerability, that is the risk of falling into a transient episode of poverty or temporarily getting deeper into poverty. In Indonesia, for example, studies have shown that the incidence of vulnerability ranges between 34 and 50 per cent of the population vis-à-vis approximately 20 per cent of the population officially classified as poor. Furthermore, vulnerability went up in a sharper fashion than current poverty during the 1997 crisis.

A major form of vulnerability is exposure to labour market risks entailing such phenomena as fluctuating real wages, unemployment, underemployment and curtailed job

60 Easterly (2001), among others, notes that an index of infrastructure development (telephone lines per 1000 persons) is a statistically significant explanatory variable in cross-country growth regressions. A bivariate regression using long-run, cross-country data yield the following statistically significant relationship (at 1 % level of significance) between (log of) poverty ($1-a-day; pov1) and the afore-mentioned (log of) index of infrastructure development (Tel): $pov1 = 0.605 -.072 Tel, R-Square: 0.412

61 Ravallion (2002).


opportunities in the formal sector following macroeconomic crises or even structural reform (such as job-shedding due to privatisation and trade liberalisation).\textsuperscript{64}

Such labour market risks should not be dismissed as the normal dynamics of a market economy or be seen as best met by informal systems of social protection (entailing a combination of individual resilience and community-based support). There is now a growing body of professional opinion that more formal mechanisms are necessary to assist individuals, households and communities in coping with change, especially if such change is unanticipated.\textsuperscript{65}

There is also a growing professional opinion that the relentless pace of globalisation has enhanced, rather than moderated, the vulnerability of national economies to externally driven crises and that globalisation can reinforce underlying inequalities in a society. These risks create the potential for a major backlash against globalisation. Hence, social protection may be seen an attempt by the state to mitigate the risks associated with an increasingly integrated world economy. This in turn serves as an instrument for mobilising political commitment to harnessing the potential benefits of globalisation.\textsuperscript{66}

Apart from acting as a ‘shock absorber’, a well-designed and comprehensive social protection system can sustain effective demand by reducing the incidence of ‘under-consumption’ in a market economy (as measured by the incidence of long-term poverty after adjusting for interventions through social protection initiatives). Indeed, recent evidence from the industrialised countries shows that in the absence of a tax-financed social protection system, poverty would have been between 47 per cent (in USA) and 91 per cent (Finland) higher than what is typically observed.\textsuperscript{67}

While the case for social protection is by now well accepted, there is a complex range of policy issues that emerge in the design of social protection measures. These issues will be illustrated by highlighting two well-known instruments for dealing with vulnerability. The first pertains to unemployment benefits schemes, the second to public works. There are other direct and indirect mechanisms for dealing with vulnerability, such as training of retrenched workers, social funds to support community-driven projects, micro-finance entailing savings, insurance and credit. However, in order to maintain some focus on the discussion, only unemployment benefits and public works will be considered here. The former deals with formal-sector workers, the latter with informal-sector workers and those who are associated with the rural economy. In combining the two elements of social protection, the discussion recognises that the primary challenge in most developing economies is to incorporate the ‘excluded majority’ in any state-led scheme that aims to empower individuals in dealing with vulnerability.\textsuperscript{68}

The case of unemployment benefits

Unemployment benefits schemes have perhaps been the most durable feature of social protection policies in the industrialised countries. A well-known justification for their implementation and persistence is that the private sector is unlikely to insure individuals against the systemic risk of recessions in market economies.

\textsuperscript{64} Other labour market risks include unanticipated ‘incapacity’ due to illness and work-related injury. These issues are not discussed in this paper. For an overview, see ILO (2000), Chapters 4 and 5.

\textsuperscript{65} See, for example, Morduch (1999).

\textsuperscript{66} See, for example, Bergsten (2000) who argues that the backlash against globalization has to be taken seriously and social protection in national economies should be among the key initiatives for dealing with this backlash. See also Rodrik (1999) who offers a social agenda for ‘making openness work’.

\textsuperscript{67} The methodology entails comparing poverty rates based on disposable income (that includes social security benefits and income tax adjustments) with poverty rates based on factor income. See ILO (2000: pp.40-41).

\textsuperscript{68} The literature on social protection in developing economies now focuses on the challenge of dealing with the ‘excluded majority’. See, for example, Beattie (2000), van Ginneken (1999), ESCAP (2000), ILO (2000b) and World Bank (2000b).
There has, however, been a general reluctance to adopt unemployment benefits schemes in developing countries, even in cases where reasonably generous social security programs (pertaining to old age provisioning, health care, employment-related injury etc) exist. One review, for example, finds that only four countries in Asia have either unemployment insurance or unemployment assistance. Various objections against unemployment benefits schemes may be made. Thus, one could argue that they are fiscally unaffordable for developing economies. They do not fit the poverty alleviation objective because unemployment is a ‘luxury’ that the poor can ill-afford. Unemployment benefits have disincentive effects because they tend to increase the duration of voluntary unemployment and could become entrenched as ‘entitlements’ that are politically difficult to remove.

Despite the reservations against unemployment benefits, there has been some resurgence of interest in exploring their applicability to developing economies in the wake of the Asian crisis. An ILO study has argued the case for introducing unemployment insurance schemes in East Asian economies. Estimates suggest that ‘…an average required contribution rate of between 0.3 to 0.4 per cent of payroll between 1991 to 2000 would have been sufficient to provide all insured job losers over this period, including during the current crisis, with 12 months of benefits’. Another independent study claims that ‘…most of the Asian economies…should be able to operate (an unemployment insurance programme) with OECD generosity utilising an average payroll tax rate of 1.0 per cent’.

Those who advocate the installation of unemployment benefits also question whether the disincentive effects of such a scheme are large. At least some studies claim that they are moderate and that they really apply to the extreme case of an unconditional payment of a uniform rate to all beneficiaries for the entire duration of unemployment.

There is a stronger body of theory that argues that an economy without unemployment insurance can be trapped into a ‘low-level equilibrium’ of low-productivity jobs that workers readily accept in order to avoid the risk of unemployment. Firms respond to this preference by supplying such low-productivity jobs and charging an insurance premium in the form of lower wages. Under such circumstances, a moderate level of unemployment insurance can encourage workers to take on more risks and increase both aggregate welfare and output.

It is also worth emphasising that all sensible unemployment benefits schemes that operate in the industrialised nations have, over the years, incorporated features that can reduce the alleged disincentive effects. These include well-specified eligibility criteria, limited duration of benefits and demonstrated evidence that beneficiaries are actively engaged in job search and mandatory acceptance of job offers. Some practitioners have also suggested ways in which, in an East Asian context, the problems associated with unemployment benefits schemes can be ameliorated.

Whatever the future shape of an unemployment benefits scheme in developing countries, it will leave out a large fraction of the workforce in the informal sector, and those in

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70 Lee (1998: Chapter 4).
71 The calculations assume that the coverage of the scheme would be the same as existing social security provisions and would provide 12 months benefit at a replacement rate of 50 per cent of previous earnings.
72 Vroman (1999:37)
73 See, for example, Atkinson and Micklewright (1991).
75 See Edwards and Manning (1999) who argue the case for an ‘unemployment savings account’ that will be self-financing and with benefits tightly linked to contributions. These authors concede, however, that the system will, at the very least, require employers and employees to be identified with a unique number, and the information system as a whole must be efficient and up to date. Not surprisingly, the authors express concerns that there simply may not be the administrative capacity for meeting these institutional prerequisites.
self-employment and in rural areas. Hence, discussions of alternative forms of employment protection are necessary. Perhaps the best known example is public works – or workfare.

**The case of public works**

Public works have been, and are, quite common in many developing countries. However, in common with other social protection measures, they can be beset by a number of problems. A recurring issue is that the institutional mechanisms for protecting the poor from adverse shocks usually are not in place before hand. As the Asian financial crisis demonstrated, policy-makers frequently have to improvise programs as an emergency response to a crisis and rely on projects and programs designed for beneficiaries and objectives other than crisis-mitigation. This suggests that insufficient time and thought are given to design and implementation issues. Workfare programs should be carefully crafted and institutionalised as built-in social protection measures prior to the onset of a crisis.

Guidelines now exist on good design features that can make a public works program operate effectively, in a developing country context. These features include the need to set wages at a level no higher than the market determined rate for unskilled manual workers. Another possibility is to set wages at a small multiple (say 10 per cent) of the prevailing poverty line. One advantage of such a deliberate policy of low wages is that it causes the programme to become ‘self-targeting’, that is, it is likely to attract only those who need work at such a wage rate. This economises on the need to impose elaborate eligibility criteria for screening out poor from non-poor individuals. The projects should try to target poor areas and should strive to create assets that are of value to poor communities. Where the non-poor groups are likely to be significant beneficiaries of such created assets, co-financing should be mandatory and should be ploughed back into the budgets of public works projects.

Finally, there is the issue, as in the case of unemployment benefits scheme, of the fiscal affordability of social protection initiatives such as public works. The available evidence suggests that ‘costs of safety nets need not be large even if they reach a large number of beneficiaries’. Typically, the cost of operating workfare programs are well below 1 per cent of GDP, while social safety net expenditures represent a modest proportion of the budget.

4. **Empower labour market institutions rather than entrench labour market flexibility**

The notion of flexible labour markets relatively free from state intervention is an article of faith among those who subscribe to neoliberal macroeconomics. The implication is that governments can concentrate on fiscal and inflation targets without explicitly incorporating employment objectives in macroeconomic policy. A related implication is that unemployment and underemployment are largely caused by labour market rigidities – strong unionism, such as minimum wages legislation and assertive ‘social’ regulation pertaining to working conditions. However, studies of successful small European economies show that

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76 These guidelines draw on Ravallion (1998), Subbarao (1997) and World Bank (2000b)
77 Lustig (2000:17)
78 The Mexican Progresa costs about 0.2 per cent of GDP with 2 million households as beneficiaries. The Trajabar program in Argentina reaches 350,000 costs a quarter of one per cent of GDP. In Indonesia, safety net operations cost about 2 per cent of the central government’s budget. (Lustig, 2000). During the crisis, it probably prevented several million from sliding into transient poverty (Dhanani and Islam, 2002).
macroeconomic conservatism succeeded in maintaining employment growth and price stability because they were underpinned by socially negotiated wages policy in a context of well-developed labour market institutions. Unrestrained labour market flexibility was not the solution.79

Developing countries cannot, of course, expect to emulate the labour market institutions of advanced European economies, but seeking to entrench labour market flexibility in the process of development is also highly problematic. Uncritical endorsement of labour market flexibility impedes the development of labour market institutions even in a minimal sense (freedom of association and trade union rights) and leads to chaotic industrial relations that may be prejudicial to both growth and macrostability.

Fortunately, the ideological divide on labour market flexibility that once existed in the international community is beginning to blur.80 There is growing recognition that freedom of association and trade union rights are critical in developing credible and durable industrial relations system that are in turn conducive to both growth and macrostability. At the same time, econometric studies using cross-country data show that the adoption of core labour standards is not inimical to growth and, in some cases, may even have a positive impact on certain growth-promoting variables, such as FDI.81

5. **Encourage the development of an inclusive approach to policy-making through democratic deliberations**

The notion of an inclusive approach to policy-making is closely related to the ILO’s notion of ‘social dialogue’, where the latter may be defined as all types of negotiation, consultation or simply exchange of information between representatives of governments, employers and workers on issues of common interest relating to economic and social policy. The value of such participatory processes, which can occur at enterprise, industry-wide and national levels, as a key instrument for constructing economic and social policy is now widely accepted.82 Perhaps what differentiates the ILO from others is the linking of public deliberation to the principle of tripartism (government, employers, unions) rather than linking it to all pertinent stakeholders – such as non-workplace-based civil society organisations. The rest of the discussion will rely on this more focused definition of social dialogue, but it will emphasise the utility of broadening the scope of the dialogue partners.

Why are democratic deliberations of pertinent policy issues necessary? One could argue that the primary rationale resides in the construction of trust among parties with different interests who pursue common economic activities in the presence of asymmetric information.83 Thus, employers have an interest in maximizing the returns to shareholders, while workers are primarily concerned with wages and working conditions. Yet, the act of production requires cooperation despite the disparate interests of the key actors. When

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80 Freeman (1993) raised the issue of an ideological divide between ILO and the World Bank on labour markets, with the former advocating strengthening labour market institutions and the latter calling for labour market flexibility. The Bank has since then offered a more circumspect view (see, for example, World Bank 1995). For an excellent example of recent collaboration on studies on labour markets between the Bank and the ILO, see Betcheman and Islam (2001).
82 As noted in this paper, the PRSPs for developing countries that are being advocated by the Bretton Woods institutions rely heavily on the notion of participation and public consultation.
83 See Campbell (1999: 3–8)
employers and workers do not trust each other, several consequences may endanger such cooperation: withholding of information by either party that supports appropriate decision-making at the workplace, resort to ‘exit’ strategies by workers, such as quits, low morale and commitment to work and even resort to downright violence. Hence, workers need to be given a ‘voice’ mechanism through which information can be shared and trust built up.

Information-sharing and trust-enhancing processes are particularly useful when drastic adjustments – such as layoffs, wage cuts, shorter working time – have to be made in the presence of macroeconomic shocks. A commitment to the equitable sharing of the inevitable costs of adjustments is likely to be more durable if decisions are collectively constructed through deliberation and negotiation among employers and workers (with the government acting as a third party).

Beyond its potentially valuable impact on easing the process of labour market adjustments triggered by macroeconomic fluctuations, the instrument of social dialogue also engenders wider benefits. Thus, it can be a useful tool in nurturing democratic values. It can also respond to important dimensions of poverty, namely, voicelessness and powerlessness, which have been highlighted in recent studies.84

What are some of the key constraints and challenges that would inhibit the development of an inclusive approach to policy-making in developing countries? What can be done to respond to them?

The problem is partly ideological. There is the well-known view that key policy decisions can be made effectively and quickly only by specialists and technical experts insulated from free flowing public discourse. Given such a mindset, social dialogue is likely to be perceived as the thin end of the wedge that eventually subjugates the formal policy-making machinery to narrow group interests.

The notion that economic policy-making ought to be the preserve of benevolent technocrats is slowly changing. For example, the current generation of PRSPs with their emphasis on participation and consultation is a useful development. Admittedly, public consultations of a national policy document are subject to dual dangers. They can either become mud-slinging matches among the uninformed and the prejudiced or mere rituals engaged by bureaucrats to respond to the democratic aspirations of civil society. There are no easy solutions to these problems, but at least the public consultations underpinning PRSPs represent a promising start in the right direction.

The effectiveness of ILO’s tripartite principle as applied to social dialogue may be diluted by the weaknesses of the dialogue partners. The key actors usually are the employment ministries, trade unions and employers associations. Employment ministries are usually line ministries that are subordinate to the key strategic ministries and agencies, most notably the finance ministry and the central bank. The latter form the primary national stakeholders in negotiating with donor agencies in fashioning any macroeconomic package to deal with a crisis. The effectiveness of such a package requires a social consensus on sharing the short-run costs of adjustments. Such consensus ought to be crafted through social dialogue, but one can hardly expect employment ministries to play a leadership role. It is usually not the major player in the development of a macroeconomic package.

There is a case, it seems, to enlarge the domain of dialogue partners even if it means straying beyond the strict interpretation of ILO’s tripartite principles. Certainly, the government’s representation in social dialogue should not focus simply on employment ministries, but should incorporate the strategic ministries and agencies closely connected to the development of macroeconomic policy. This will enhance the probability that labour

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84 See in particular Narayan et al. (1999).
market issues will receive attention as part of the design of a macroeconomic policy package.\footnote{It appears that some of the more successful examples of social dialogue in the crisis-affected East Asian economies, such as Malaysia and South Korea, bear the imprimatur not just of the strategic ministries, but of the presidential/prime ministerial office. See Campbell (1999).}

Another way in which the domain of dialogue partners may be enlarged is to tap into the network of ‘public intellectuals’ comprising university academics and representatives of think-tanks who can play an important role in forming elite opinion on topical social and economic issues. Their role has been enhanced by the democratic transition taking place in many developing countries. This has opened up enormous opportunities for influencing public debates through a largely free media. Their spirit and intellectual energy could be harnessed more effectively than has perhaps so far been done to support the role of the traditional dialogue partners.

One should also highlight the challenges facing employers’ organisations, and business in general, in supporting the process of social dialogue. Business associations prefer the time-honoured technique of investing resources in lobbying ministries and political parties for influencing national policies. If the returns to lobbying are higher than the returns to investments in social dialogue, the predictable incentives are to reduce support for the latter and put more effort into the former.

The issue of lobbying by business groups is complex but if, over time, business groups find that there are alternative, and credible, channels for representing their causes to society at large and to the government, then they are more likely to support the process of social dialogue. This shifts the onus back to the government in exercising leadership on embedding public discourse as a core element of transparent and accountable policy-making.

Perhaps one of the biggest challenges facing the development of social dialogue in developing countries is the lack of a viable trade union movement both in terms of representation and capacity. This is compounded by the fact that own-account workers and the informal sector represent a very significant proportion of the workforce. How does one develop credible ‘voice’ representation for this excluded group? This is where one may need to work creatively with non-workplace civil society organisations with a credible record of representing the poor. Linking the trade union movement to emerging pro-poor associations could turn out to be a promising route for a broad-based coalition that embeds ‘voice’ representation for the poor.

Finally, a relevant issue that crops up in the discussion of social dialogue is that public deliberations are not costless. They use up scarce fiscal resources stemming from the logistics of hosting social dialogue on a regular basis. One could argue with some plausibility that cash-strapped governments are unlikely to attach priority to investing budgetary resources in hosting public deliberations. This is a valid concern, but it can be addressed. Co-financing by the non-governmental dialogue partners (especially business associations) is always possible and desirable. Donor assistance could also be tapped in creating a trust fund that could be dedicated to funding initiatives in national dialogue.\footnote{Dan Morrow of the World Bank evokes the example of Bolivia which has such a dedicated trust fund managed by the UNDP. These observations were made by Morrow in the \textit{UN Poverty Retreat}, Tarrytown, New York, 20 July 2000.}

6. **Temper the influence of global investors on a national macroeconomic agenda by adopting a circumspect approach to capital mobility**
In its annual meeting in Hong Kong in September 1997, the IMF issued a statement that endorsed an eventual move to capital account convertibility among IMF members. This was a fundamental departure from the 1994 Article of Agreement that included current account liberalisation only as an obligation and a goal; it did not embrace capital account convertibility as an obligation and an eventual goal. At the time, the 1997 financial crisis was in its infancy and failed to dampen the enthusiasm of the advocates of the ‘Washington Consensus’ that deep economic integration entailing both trade and capital account liberalisation would create and sustain national prosperity across the world. Since then, there has been a strategic retreat from such a position. There is a growing realisation that short-term capital mobility imposes a number of costs on developing countries that can no longer be ignored.

As noted, short-term capital mobility creates an environment in which the interests of global investors cast an inordinate influence on a national macroeconomic agenda by creating a bias in favour of low inflation and fiscal conservatism irrespective of country-specific circumstances. While some studies have claimed positive economic benefits of an open capital account in terms of faster growth and lower inflation, the professional literature has generally been far more circumspect. Indeed, a recent study by William Easterly et al claims that ‘…countries with more open capital accounts are more likely to go into recessions’. Recessions of this nature in turn can lead to sharp, albeit transient, increases in poverty, collapse in real wages and a rise in unemployment/underemployment. One should also take account of high fiscal costs entailed in taking over bad loans and recapitalisation of insolvent banks that typically emerge following a macroeconomic crisis induced by capital outflows. To make matters worse, the burden of bearing such costs is unevenly shared. They are typically borne by ordinary citizens and taxpayers, while the direct benefits of ‘cleaning up’ the banking system are reaped by relatively well-off domestic and international investors.

It is thus not surprising that controls on short-term capital inflows as a way of reducing the risk of the recurrence of financial crises in developing countries and as a way of restraining the influence of global investors on a national macroeconomic agenda has emerged as an important issue in current global policy debates. Such controls would entail a combination of taxes and quantitative restraints of a prudential nature and assist in lengthening the average maturity of external debt. Advocates of capital controls could point to the fact that China weathered the Asian financial crisis so well largely because they had such controls in place. They could also point to the experience of Malaysia that instituted capital controls in September 1998 – an initiative that has even won guarded approval from the IMF.

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87 This seems to have been mitigated by more recent events. For example, the US government has used the device of FTAs (Free Trade Agreements) that it is negotiating with various countries to pursue the cause of financial integration. In the case of Singapore, the US govt has said that, as part of signing the FTA, the Singapore govt must give up its sovereign right to impose capital controls even in an emergency (Straits Times, 26 Nov, 2002).

88 Quinn (1997)

89 Rodrik (1998)

90 Easterly et al (1999:43)

91 In the Mexican crisis of 1994-1995, the cost of cleaning up the banking system has been estimated around 19 per cent of GDP (Financial Times, September 16, 1999).

92 Perhaps the most widely cited case of imaginatively designed capital controls is that of Chile. Policy-makers combined market-based instruments with non-remunerative reserve requirements on short-term flows. There is also a resurgence of interest in the Tobin tax, advocated by James Tobin in 1972. The proposal entails the imposition a uniform, but moderate, tax on spot transactions in foreign exchange (see Kaul et al, 1996).

93 In an interview with CNBC Asia, the former managing director of the IMF said: ‘I praise the way in which Malaysia has been able to adopt a soft system of controls’ (Development News, World Bank, 20 May, 1999). See also Kaplan and Rodrik (2001) for a positive evaluation of the Malaysian experience. Critics typically argue that capital controls cannot be held
Of course, capital controls can generate allocative inefficiencies. They should not be seen as a substitute for sound economic policies. Gradually, as financial systems approach international standards, a country can ease capital controls to reap the rewards of globalization. At the same time, one must remember that it can take a long time to build domestic financial institutions and prudential regulation in developing economies to the required international norms. The alternative approach – of hasty and premature capital account liberalisation – that characterised pre-crisis Asia produces undue risks and uncertain gains.

**7. Create an enabling international environment to complement pro-poor, employment-friendly macroeconomic policy agenda at the national level.**

Recent macroeconomic crises have been contagious in nature, that is, they affect a range of countries even though they may not be closely related and have distinct economic, institutional and social characteristics. While institutional and weaknesses and policy errors in certain countries do play a role, macroeconomic contagion cannot simply be explained as the product of irresponsible fiscal, monetary and structural weaknesses. There is a growing recognition that, since macroeconomic crises and their consequences spill across national borders, a combination of international and regional cooperation is needed to complement national initiatives.

The need for international cooperation to deal with macroeconomic contagion has led to rethinking on ways of dealing with unsustainable sovereign debt that is often the legacy of such contagion. The traditional approach is for IMF-led large-scale international bailouts of crisis-affected economies. This approach is seen as wasteful, ineffective and afflicted by the suspicion that they end up bailing out international creditors. This has bred propositions for designing more effective sovereign debt restructuring schemes. The aim is to reduce unsustainable external debt problems that periodically afflict developing countries but at the same time enable them to reap the benefits of external finance. This would entail balancing the interests of creditors (usually from the rich nations of the world) and debtors (usually from the developing countries) by ensuring that the former are at least partially responsible for poor lending decisions. One proposal from the IMF contemplates a ‘...sovereign debt restructuring mechanism that would empower a debtor and a super-majority of creditors to take the key decisions in a restructuring in a timely and efficient way’. It remains to be seen whether these proposals will be adopted and work effectively. Critics contend that the Bretton Woods institutions still do not show any credible sign of disengaging from the traditional approach of large-scale international bailouts.

Closely related to the issue of debt restructuring is debt relief. Until the mid-1990s, any serious attempt to deal with the growing debt problems of very poor countries through large-scale debt relief was not a key part of the policy agenda of the Bretton Woods institutions. Largely as a result of civic activism coordinated globally by the Jubilee 2000...
movement that was launched in 1996, debt relief has now become a core part of global policy debates. The Bretton Woods operate a ‘HIPC’ (heavily indebted poor countries) initiative that processes debt relief programmes on a case-by-case basis. Critics contend that the HIPC process is agonisingly slow. It appears that the HIPC initiative is now formally linked to the PRSP (Poverty Reduction Strategy) process that could build up considerable bureaucratic inertia against the speedy disbursement of debt relief (see the discussion on PRSP in this paper).

While progress on debt relief is proceeding at an unsatisfactory pace for the poorest countries of the world, the prospects for extending the idea to cover middle-income developing countries seem even less likely at this stage. Instead, such countries have been the targets of large-scale international bail-outs that, as noted above, critics have found ineffective and wasteful.

The emerging theory of ‘odious debt’, proposed by Micheal Kremer and Seema Jayachandran, suggests a way in which debt forgiveness could be extended to any developing country and not just remain limited to HIPCs. This is the idea that many developing countries are carrying ‘odious debt’ incurred by autocratic rulers who used such funds for personal gain and to maintain their anti-democratic authority. They propose new institutional arrangements that would simultaneously discourage the creation of odious debt by creditors in rich countries and their payment by successor governments in developing countries. Thus: (a) one could create an independent institution vetted by the world’s leading powers and international organisations that would declare a regime odious and announce that legitimate successor (e.g. democratically elected) governments would be justified in repudiating such debt; (b) change laws in creditor nations such that seizure of a country’s assets would be disallowed in the event of a non-repayment of odious debt; (c) foreign aid to successor governments would be contingent on non-repayment of odious debt.

The net effect of these proposed arrangements, the authors argue, would minimise the build-up of odious debt across a wide set of developing countries, facilitate the ability of legitimate governments to borrow in international markets, attract foreign investment and enable them to finance much-needed development activities in a non-inflationary way. While innovative, there are doubts whether the international community will seriously consider these ideas. Financial interests in the creditor nations are a powerful lobby. Such a bbby could regard the notion of ‘odious debt’ as part of an attempt to curtail their capacity to exploit their comparative advantage to trade in financial services with the rest of the world. The Bretton Woods institutions too might lack the incentive to endorse the policy implications that follow from the theory of odious debt. International bail-outs provide a well-entrenched mechanism for such institutions to exercise their power and influence in the policy-making processes of a wide range of developing countries. Finally, one must not overlook the challenges of classifying odious debt. While some cases might be quite clear, such as the apartheid government in South Africa, Somoza in Nicaragua, Marcos in the Philippines, Duvalier in Haiti, Mobutu Seko in former Zaire, Abacha in Nigeria, others are likely to be more contentious, such as the Suharto regime in Indonesia.

Despite such caveats, it is clear that the issue of debt relief, whether justified from the perspective of the theory of odious debt or on compassionate grounds, will remain as a core element of global policy debates on the need for dealing with macroeconomic contagion and its consequences.

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98 Kremer and Jayachandran (2002)
99 Jeffrey Winters (2001) has argued that the current democratically Indonesian government is carrying ‘criminal debt’ from the previous authoritarian regime and deserve to be considered for large-scale debt relief.
There are also much more contentious proposals for crafting a new era of development cooperation that go well beyond issues of sovereign debt restructuring. One could argue that current institutions of global economic governance suffer from impaired legitimacy as they do not provide sufficient scope for the voices and concerns of developing countries to be aired. The idea of nationally-owned and driven development strategies that are currently enshrined in the PRSPs is, of course, an attempt to deal with such grievances. On the other hand, as a preliminary evaluation of the PRSPs has shown, it has not been easy for the PRSPs to disengage from the constraints of economic orthodoxy.

A growing number of influential voices are now arguing that, to remain at the forefront of development policy and practice, institutions of global economic governance, most notably the Bretton Woods institutions, must confront their impaired legitimacy, despite the commendable attempts that these organisations have made in recent years to improve transparency and accountability in their operations and decisions. Others have argued that there should be clear separation between policy analyses, research and the operational activities of the Bretton Woods institutions by ensuring that the former are carried out by independent agencies. Currently, the research departments are located within these institutions, creating the risk that some of the politically sensitive policy-oriented research could be used to justify the operational imperatives of the World Bank and IMF. Critics maintain that it is through the lending operations and ‘country assistance strategies’ that the largest shareholders of the two institutions seek to exercise strategic influence.

While it is easy to dismiss the above proposals as too contentious and hence unlikely to be ever seriously considered by the international community, what is clear is the need to move away from the compulsion of an artificial consensus on global policy issues. It is necessary to nourish the spirit of eclecticism and intellectual diversity anchored in the idea of country-specific approaches to macroeconomic policy as part of a holistic approach to development.

Finally, given the regionally specific nature of recent macroeconomic crises, there is an emerging movement that seeks to develop regional and financial cooperation to supplement multilateral efforts in devising an effective approach to reducing the probability – as well as the consequences – of macroeconomic contagion. The idea was first mooted with the onset of the 1997 financial crisis in East Asia and took the form of a proposed Asian Monetary Fund (AMF) to supplement the financing facilities available through the IMF. Recent developments suggest that the idea of a regional financial architecture to supplement conventional multilateral arrangements is emerging with renewed vigour. A good example is the so-called Chiang Mai Initiative (CMI). Stemming from a meeting of Finance Ministers from the ‘ASEAN +3’ group held in May 2001 in Chiang Mai, Thailand, the CMI called for: (a) an expanded ASEAN Swap Arrangement that entails all ASEAN countries and a network of bilateral swap and repurchase agreement facilities among the ASEAN +3 group; (b) regular information sharing among the members of the group; (c) a regional financing arrangement to supplement international facilities; (d) an early warning system to reduce the probability of financial crises and thus promote financial stability in the country. A recent evaluation of the CMI by the ADB suggests that ‘notable progress has been achieved …’

A final observation seems appropriate at this juncture. Crafting a new era of development cooperation that will facilitate pro-poor, employment-friendly macroeconomic

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100 See, for example, UNDP (2002). See also Stiglitz (2002a).
101 Deaton (2002), Kanbur (2002) and Wade (2002b) make these suggestions.
102 The discussion draws on Rana (2002).
103 This group consists of ASEAN plus the People’s Republic of China, Japan and Korea.
104 Rana (2002:8). The author also notes that the need for greater financial and monetary cooperation is not simply limited to East Asia. In some respects, South America and West Africa has moved further than East Asia along the path of regional financial and monetary cooperation.
agenda at the national level will require an environment in which developing countries can harness an increased inflow of external resources to meet national development goals through both aid and access to export markets of the rich nations. Access to such markets depend not just on dismantling trade barriers by both rich and poor countries, but also on the ability of the developed world to create the necessary demand for developing country exports. This in turn means the need to foster and sustain buoyant domestic markets in the industrialised countries – a task that surely belongs to the domain of macroeconomic policy. After all, the key lesson of the ‘lost decades’ literature is that the growth slow-down in the developing world in the 1980s and 1990s is linked to the growth slow-down in the OECD.

Trade flows would have to be complemented by appropriate aid flows. Current calculations suggest that annual flows of development assistance will have to double from its present annual flows of US$56 billion if the world community wishes to make a credible commitment to financing the Millennium Development Goals. At the same time, renewed efforts will have to be directed in ensuring that the available quantum of aid is allocated to priority areas that directly affect growth, employment creation and poverty.

\[105\] UNDP (2002:31)
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