

# Training Module

## Training Modules of the Research Programme Economic Policies, MDGs and Poverty

Alfredo Saad Filho

Centre for Development Policy & Research  
School of Oriental & African Studies  
University of London



International Poverty Centre

Training Module No. 2  
Monetary Policy

July, 2007

## MONETARY POLICY



### 1 INTRODUCTION

This module outlines the basic principles of pro-poor monetary policy.<sup>1</sup> Monetary policy refers essentially to the government's regulation of the supply of money and the level of interest rates. These factors affect the level of economic activity, the composition of output, the structure of employment, the distribution of income and the direction of economic transfers. Monetary policy also influences fiscal policy (for example, the level of interest rates affects domestic public debt service), the balance of payments (the interest rates also influence the exchange rate and the level and direction of international capital flows) and the stability of the domestic financial system (the central bank is the regulator of financial institutions and the lender of last resort). Through these various channels, monetary policy affects the outcome of short-run stabilisation, and influences the policy remit of the state and the economic growth rate in the long run. Therefore, it can make an important contribution to a pro-poor development strategy.

International experience during the last 30 years shows that the orthodox development strategy, focusing primarily on price stability and static market-based allocative efficiency, is problematic both conceptually and empirically. The orthodox approach is plagued by inconsistencies at several levels, and its assumptions are at variance with the realities of developing countries. These shortcomings help to explain the continuing failure of conventional stabilisation and structural adjustment programmes to achieve their stated aims of rapid economic growth, poverty reduction and balance of payments sustainability. In the words of an informed researcher linked to the World Bank:

*"The single-minded pursuit of very low inflation can lock the economy into a low-employment equilibrium".*

How to explain that after sustained involvement and many structural adjustment loans, and as many IMF's Stand-bys, African GDP per capita has not budged from its level of 20 years ago? Moreover, in 24 African countries, GDP per capita is less than in 1975, and in 12 countries even below its 1960s level ... How to explain the recurrence of Latin crises, in countries such as Argentina, that months prior to the outbreak of the crisis are being praised as model reformers ... How to explain that the best 'pupils' among the transition countries (Moldova, Georgia, Kyrgyz Republic, Armenia) after setting out in 1991 with no debt at all, and following all the prescriptions of the IFIs [international financial institutions], find themselves 10 years later with their GDPs halved and in need of debt-forgiveness? **Something is clearly wrong.**<sup>2</sup>

The inability of the orthodoxy to contribute to rapid welfare gains for the poor is a severe indictment of mainstream economics, especially in the light of the substantial resources currently available in the world economy, in addition to those that could be generated through faster growth and more equitable distribution. In the light of these shortcomings, pro-poor policy alternatives deserve close consideration. Such policies aim to strengthen the connection between the Poverty Reduction Strategy Papers PRSPs and the Millennium Development Goals (MDGs) in both concept and implementation, and link the MDGs with broader human development targets.<sup>3</sup> They include some of the distributive elements of Keynesian and Kaleckian macroeconomics, enriched by a clear assessment of the role of public policy in the current era, and are deployed in order to achieve human development objectives as rapidly as possible. This module does not provide a ready-made set of monetary policy alternatives valid for every country and context, but it does offer a platform for devising alternative policies in country-specific contexts.

This module includes five sections. This introduction is the first. Section 2 outlines the orthodox approach to monetary policy. Section 3 explains the key features of pro-poor monetary policy, including its basic principles and the main features of pro-poor anti-inflation policy. Section 4 examines the problems of inflation and stabilisation in developing countries, in the light of orthodox stabilisation programmes and of the specific case of inflation targeting, which is the most important strategy of inflation control today. Section 5 draws the appropriate conclusions.

## 2 ORTHODOX APPROACHES TO MONETARY POLICY

This section reviews the analytical principles and policy implications of orthodox monetary policy. It starts from a historical review of the evolution of orthodox theory, focusing on the rise and decline of the neoclassical synthesis, and on the closely related issue of the economic fortunes of rich countries in recent periods. It subsequently reviews the structure and policy implications of the financial programming model associated with the IMF.

### 2.1 ORTHODOX THEORY AND MONETARY POLICY

Monetary policy is important because it influences the levels of output and employment, and the rate of economic growth. These aspects of monetary policy are normally emphasised in most macroeconomics textbooks, and they do not need to be reviewed here. However, monetary policy is *also* important because it influences the composition of output and employment, the level and direction of economic transfers, the distribution of income and wealth, and the modalities of state intervention in the economy. Even though these implications of monetary policy are as a rule treated only superficially (if at all) in conventional textbooks, they are very important for our purposes. Looking at monetary policy from this angle highlights the social and distributive implications of macroeconomic policy – in other words, the degree to which economic policy is pro-poor.

The difference is the following. Conventional textbooks normally focus on the aggregate demand implications of monetary policy changes. For example, what happens to the GDP growth rate given a one per cent change in real interest rate? This is a very important question, but it completely bypasses the distributive implications of macroeconomic policy. If one is concerned with the latter, and with poverty reduction more generally, it is essential to go beyond generalities and review how monetary policy affects both macroeconomic stability and distribution *at the same time*.

Although *all* forms of aggregate demand control can be effective at the macroeconomic level, they will stimulate (or, alternatively, curtail) different types of expenditure and bring gains and losses to distinct groups. The composition of output and employment, the distribution of income and the structure of employment will, correspondingly, be *different* depending on the monetary policy adopted by the state. For example, demand contraction through high interest rates can create unemployment for some (e.g., workers producing tradable goods in heavily-competitive markets, where there is little scope for increasing prices in response to adverse cost pressures), but it can bring windfall gains for others (especially to rentiers living off interest payments). Alternatively, the same shift in aggregate demand could be obtained through a fiscal contraction achieved not through expenditure cuts, but, rather, by increasing taxes on capital gains without a corresponding increase in government spending. Gains and losses will be very different in each case (in the latter, rentiers lose out in the first round, while in the second round the foreign and domestic producers of luxury goods consumed by rentiers will also tend to lose). If we are concerned with a pro-poor development strategy, rather than simply with 'growth' in general, it is essential to investigate the *distributive implications* of alternative monetary policy measures, even if this investigation is seldom explicitly done in orthodox analysis.

Conventional strategies of aggregate demand control were at the core of the so-called 'neoclassical synthesis', which inspired macroeconomic policy in rich countries during the first thirty years after World War II. The neoclassical synthesis absorbed some of the key insights of J. M. Keynes's *General Theory of Employment, Interest and Money* (Keynes 1973, originally published in 1936) into neoclassical economic theory. During this period, interventionist states essentially sought to fine-tune the level of aggregate demand in order to ensure that both unemployment and inflation rates would be low and stable.<sup>4</sup> These policies were prominent in most OECD countries, especially France, [the former] West Germany and Japan, while similar policies (with a more heavily developmentalist emphasis) were adopted in such newly-industrialising countries as Brazil, India, Republic of Korea, Mexico, South Africa and Turkey.

In spite of the considerable success achieved by policy-makers over long periods of time, the world economy was hit by severe difficulties between the late 1960s and the mid-1970s. During that period, most countries experienced a significant slowdown in growth and a sharp increase in both unemployment and inflation, which the Keynesian economists could neither adequately explain nor address. Loss of economic dynamism among rich countries induced a sharp deterioration of the terms of trade of most poorer economies. Many countries attempted to borrow their way out of these troubles, but most were eventually enmeshed in a profound economic crisis from which many have yet to extricate themselves completely.<sup>5</sup>

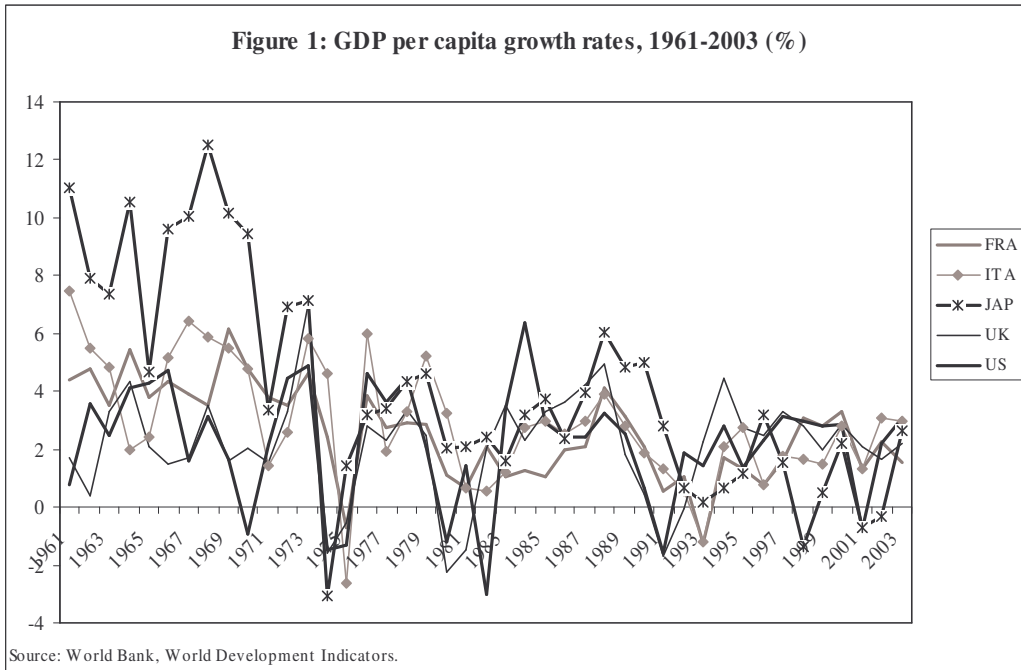
As these economic crises gradually worsened, monetarist economists led by Milton Friedman raised important theoretical challenges against Keynesianism and the neoclassical synthesis. They questioned the validity of the Keynesian consumption function and his theories on investment and savings (which underpin the use of monetary and fiscal policies to control aggregate demand), argued that government activism is inflationary, and claimed that slow growth, high inflation and

high unemployment were the inevitable consequences of a departure from the 'sound' principles of free market economics. Such criticism was not generally considered as significant while the neoclassical synthesis seemed to work. However, the popularity of monetarism rose rapidly when the world economy took a turn for the worst and the Keynesian economists found themselves unable to offer credible explanations or workable policy alternatives.<sup>6</sup>

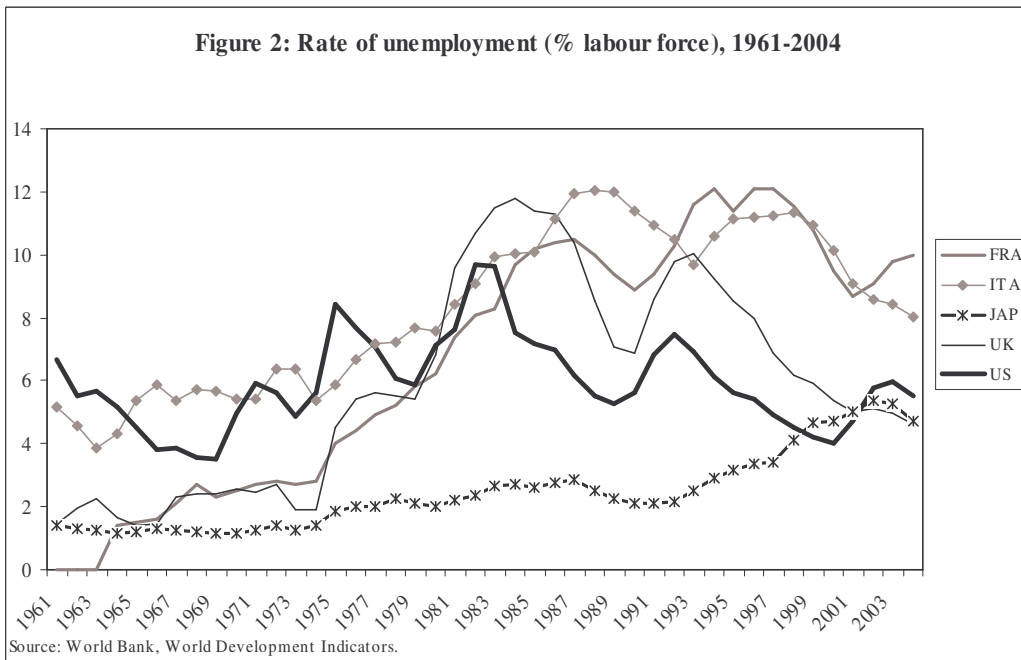
In the mid-1970s, several Western governments implemented monetarist policies, especially the United Kingdom (in 1976) and the U.S.A. (in 1978-79). These governments abandoned attempts to fine-tune the level of aggregate demand in the short run and, in practice, revoked their commitment to employment creation and macroeconomic stabilisation. **Inflation control** became the most important goal of economic policy. Presumably, once a favourable macroeconomic environment were in place, the market would spontaneously restore growth and high levels of employment. In the late 1970s and early 1980s, macroeconomic policy in many advanced countries aimed primarily at throttling inflation through the containment of labour demands, the retrenchment of state economic activity and the imposition of money supply targets, as monetarists had suggested.

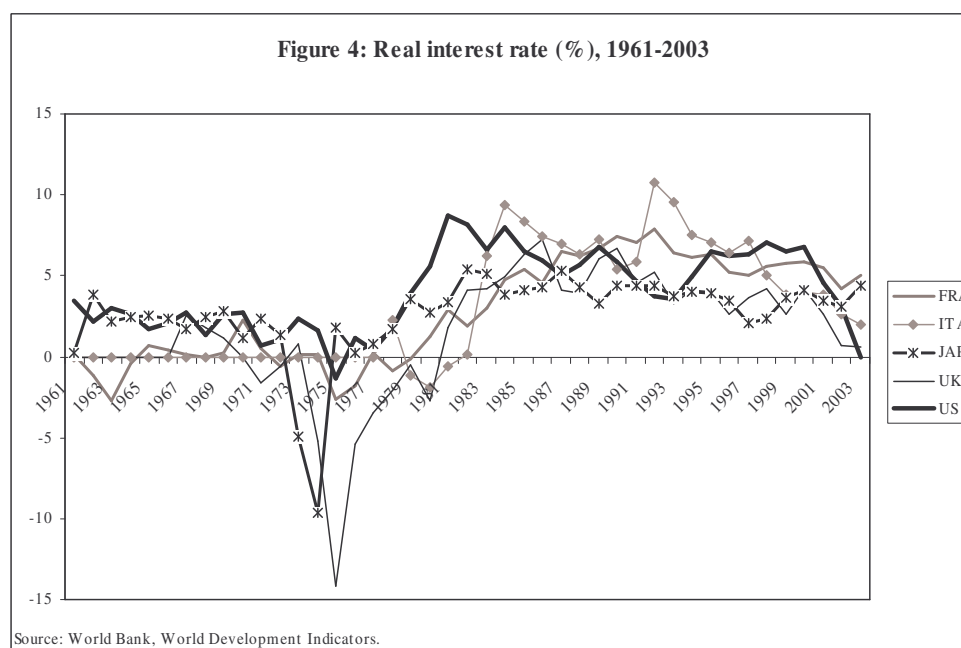
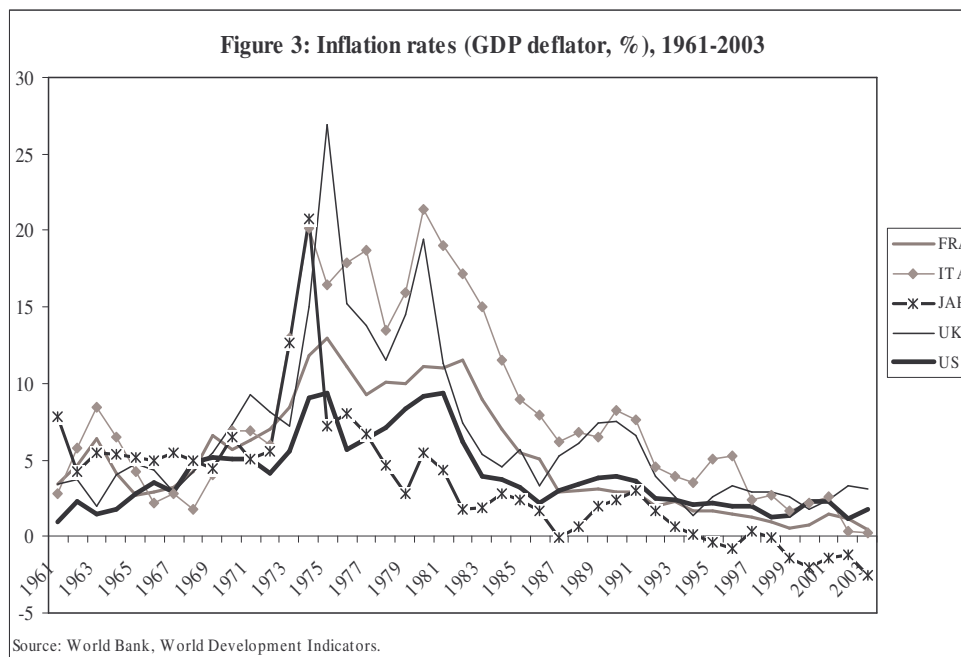
Unfortunately for the monetarists, the experiences in Germany, Switzerland, the United Kingdom, the U.S.A. and elsewhere did not vindicate their claims that money supply targeting was either feasible or conducive to inflation stabilisation. In addition to these practical difficulties, monetarist theory was badly damaged by severe criticism inflicted by new classical, Keynesian and radical political economists.<sup>7</sup> Moreover, GDP growth rates failed to recover, unemployment stabilised at relatively high levels almost everywhere, while a confrontation between the state-business alliance and organised labour created severe social conflicts in many countries. Inflation declined only slowly, and not because of money supply targeting (which was generally a failure, even in its own terms). Inflation fell when real wages slipped and commodity prices tumbled (i.e., the cost of inflation control in the rich countries was paid, in part, by the workers and the poor in these countries and, in part, by the developing countries) after interest rates were raised to unprecedented levels in order to 'break the back' of inflation.

Figures 1-4 illustrate these developments through a comparison of five representative rich countries, France (FRA), Italy (ITA), Japan (JAP), the United Kingdom (UK) and the United States (US). Figure 1 shows that GDP growth rates in these countries tended to decline between the late 1960s and the early 1970s, and failed to recover subsequently. Figure 2 indicates that unemployment rates increased in all countries after the early 1970s and, while they declined in the U.K. and the U.S.A., in the other countries they remained significantly higher than had been previously the case. Figure 3 shows the spike in inflation rates between the early 1970s and the early 1980s, and the slow decline of inflation in most countries. With the exception of Japan, it took a decade or more for inflation to return to its earlier levels. Finally, Figure 4 illustrates the gyrations of the real interest rate. From low positive levels in all countries in the late 1960s, it became strongly negative in the mid-1970s, especially in Japan and in the U.K. (due, largely, to the relatively high inflation rates in that period), to finally reach extraordinarily high levels which have been maintained since the 1980s (except after the collapse of the dot.com bubble).



FRA: France; ITA: Italy; JAP: Japan; UK: United Kingdom; US: United States.





In the 1980s, the monetarists had to face challenges that were very similar to those that had recently defeated the neoclassical synthesis. On the one hand, as was mentioned above, money supply targeting failed to bring inflation down rapidly and costlessly, as the monetarists had anticipated. This was severely embarrassing to them (see Box 1). On the other hand, former students of Milton Friedman developed an aggressive (and, they argued, internally consistent) brand of monetarism in the 1970s: the new classical economics. Its distinguishing feature is the rational expectations hypothesis (REH). The REH presumes that economic agents are rational and, in order to make economic decisions, they use all available information (and the correct economic models). As the agents learn to anticipate government policies, these policies become ineffective (**policy neutrality**). In its strong version, the REH implies that the economy is always in equilibrium, and that governments can never improve upon market performance. These theoretical and



empirical challenges led to the abandonment of monetarism in the early 1980s. In the prevailing economic and political climate, the fall of monetarism led to the rise of new classical economics, rather than the more progressive theories available.

The rise of new classical economics (supplemented, at a later stage, by new Keynesianism, which accepts the REH in the context of imperfect markets) strengthened the bias of mainstream economic theory towards **policy rules** rather than **policy discretion** – which was the essential condition for economic management under Keynesianism.<sup>8</sup> It also brought to the forefront of the economic policy debate mainstream concerns about the inefficiency and wastefulness of the public sector, the supposed tendency of state intervention to crowd out private sector activity,<sup>9</sup> and the costs of accommodating monetary policy.<sup>10</sup> At the same time, concerns with unemployment and distribution were displaced from economic discourse and from public policy. In their place, the orthodoxy has emphasised the importance of government action to enable the markets to ‘do their work’, the need to build up ‘confidence’ in economic policy-making, and the imperative of promoting foreign trade and investment to generate resources for growth.

This brief overview of the history of economic policy in the last decades suggests that debates about the scope for aggregate demand management and attempting to fine-tune the level of activity are conditioned, to a large extent, by different perceptions of how the economy functions. Orthodox economists believe that markets work; consequently, they tend to see the economy as being always close to full employment, in which case government intervention is generally unnecessary. Some of these economists would even insist that, if the economy is not always at full employment, this is only because of institutional distortions that can be removed through government action, for example, rigid labour markets or excessively high real wages. In this case, government intervention could even be counterproductive. In contrast, heterodox economists tend to see structural problems in the operation of markets. These problems and rigidities make unemployment and economic underperformance a serious and potentially persistent problem, which can be resolved only through government action.

#### BOX 1

##### **Monetarist Debates in the 1980s**

In their 1980s polemic against monetarism, the Keynesians and the radical political economists claimed, first, that the velocity of money and the money demand function are unstable and, therefore, the relationship between money supply and nominal income is unpredictable. Therefore, even if money supply targeting were feasible (as the monetarists claimed), it would be insufficient to control inflation.

Second, although there is always some relationship between changes in money stock and in the price level, this does not imply that growth of the money stock determines the rate of inflation. Therefore, money supply targeting can help to squeeze inflation out of the economy, but only slowly and unreliably (as is shown in figure 3) and, potentially, at a high cost. Third, government attempts in the 1970s and 1980s to control money supply while, at the same time, liberalising the financial system and the capital account of the balance of payments were self-defeating. Liberalisation modified the monetary transmission process and the links between money, finance and output. It also created incentives for the development of a whole host of financial instruments that blurred the definition of the monetary aggregates and bypassed the existing controls over the supply of money, throwing the entire exercise into confusion. The new classical economists also heavily criticised the monetarist experiment. In spite of their general agreement with the monetarist theory of inflation, the new classicals claimed that the policy shift towards money supply targeting induced changes in private sector behaviour that invalidated the predictions made by standard econometric models. Therefore, the monetarist policy recommendations were analytically doubtful, and might even be unhelpful.

The shortcomings of monetarism and the heavy criticism raised by its opponents contributed to the development of a vast literature on inflation and stabilisation after the mid-1980s, mostly drawing upon the monetarist and new classical theories of inflation. In the absence of significant wage pressures or major supply shocks during this period, inflation has become increasingly associated in the conventional economic discourse with fiscal deficits and, especially, with a lack of government policy credibility. (Obviously, this is not a comprehensive list of the potential causes of inflation; this is merely an outline of how the orthodox literature has perceived this process). This diagnosis of inflation led to recommendations for increasing credibility and introducing nominal anchors (initially, exchange rate targeting and, later, inflation targeting) in order to thwart the government's supposed incentive to surprise the public with unexpected inflation. These recommendations were usually accompanied by pressures for central bank independence and trade and capital account liberalisation in order to dismantle selected features of the Welfare State, increase labour market flexibility, curtail the remaining sources of labour unrest, and impose finance-friendly forms of fiscal and monetary policy discipline on presumably reluctant governments.

## READINGS

Campbell, A. (2005). 'The Birth of Neoliberalism in the United States: A Reorganisation of Capitalism', in A. Saad-Filho and D. Johnston (eds.) *Neoliberalism: A Critical Reader*. London: Pluto Press.

Carlin, W. and Soskice, D. (1990). *Macroeconomics and the Wage Bargain: A Modern Approach to Employment, Inflation and the Exchange Rate*. Oxford: Oxford University Press.

Clarke, S. (1988). *Keynesianism, Monetarism, and the Crisis of the State*. Aldershot: Edward Elgar.

Friedman, M. (1968). 'The Role of Monetary Policy', *American Economic Review*, Vol. 78, B1-17.

Friedman, M. (1973). *Money and Economic Development*, Toronto: Lexington Books.

Keynes, J. M. (1973). *The General Theory of Employment, Interest and Money*. Collected Works VII. London: Macmillan.

Levacic, R. and Rebmann, A. (1982). *Macroeconomics: An Introduction to Keynesian-Neoclassical Controversies*. London: Macmillan.

Marglin, S. and Schor, J. (1990). *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*. Oxford: Clarendon Press.

Screpanti, E. and Zamagni, S. (1993). *An Outline of the History of Economic Thought*. Oxford: Oxford University Press.

## 2.2 THE IMF FINANCIAL PROGRAMMING MODEL

[Note that this section is a duplication of Section 2.2 in Training Module #1 on Fiscal Policy.]

The financial programming (FP) model developed by the IMF in the late fifties offers an important example of the use of monetary and fiscal policy to achieve macroeconomic stabilisation in developing countries. The peculiarity of FP is that it focuses both on internal and external macroeconomic equilibrium at the same time.<sup>11</sup> The importance of this model cannot be over-emphasised. During the last 30 years, FP has provided the basic macroeconomic policy framework



for policy-making in an increasing number of developing countries committed to the stabilisation and structural adjustment programmes associated with the IMF and the World Bank.

The FP model extends the quantity theory of money (QTM) from a closed economy context to the open economy, in order to link domestic equilibrium in the money market (low inflation) with external (or balance of payments) equilibrium. The FP model offers policy recommendations allowing governments to address both sources of disequilibria simultaneously, which was not normally the focus of the neoclassical synthesis (see section 2.1).

The FP model includes six basic assumptions:<sup>12</sup>

1.  **$M^s = DC + IR$**  (money supply = domestic credit + the domestic equivalent of international reserves.)

This assumption implies that the domestic supply of money includes two parts. The first is domestic credit (DC) created through the monetisation of public deficits by the central bank and through the money multiplier process involving the commercial banking system. The second is the domestic currency equivalent of the country's net foreign currency reserves (IR). For example, when an exporter sells goods abroad, she is paid in hard currency, which is normally later exchanged for domestic currency either at the central bank or in the commercial banking system (depending on the country's foreign currency regulations). Consequently, the domestic money supply will rise following the increase in the country's foreign currency assets.

2.  **$M^d = Pf(y)$**  (money demand is a stable function of the price level and real output.)

This assumption expresses the QTM. It indicates that there is a stable (dependable) relationship between the demand for money, the level of real output and the price level. This assumption implies that the velocity of circulation is stable.

3.  **$y = y^*$**  (real income is fixed at the full employment level.)

This assumption implies that the economy is perfectly competitive, in which case there can be no unemployment. Since real income (or real GDP) 'y' is constant, any changes in nominal GDP ( $Y = Py$ ) must be due to changes in the price level.

4. Fixed exchange rates.
5. International immobility of capital.

These two assumptions seemed reasonable in the 1950 and 1960s, under the Bretton Woods System. They are much less appealing now, but this does not affect the gist of the model.

6.  **$X = \bar{X}$**  (fixed exports.)

The assumption that exports are fixed simplifies the analysis. It presumes that a country's exports depend primarily on the demand from the rest of the world. Since we are not interested in the other countries in this model, we presume that our country's exports are constant.

Let us now see how the model works. Suppose that the economy starts from internal and external equilibrium (full employment, balance of payments equilibrium, and money supply equal to money demand – i.e., no inflation). If DC increases for whatever reason, the supply of money (determined by assumption 1) will exceed the demand for money (determined by assumption 2). Since, for the QTM, money is not demanded on its own, when agents find themselves holding excess real balances, they will spend this excess purchasing additional goods and services.

These goods and services can include non-tradables and tradables. Excess demand for non-tradables will generate inflation, while excess demand for tradables will spill over into higher imports at constant prices and, therefore, induce a balance of payments deficit.

In order to pay for the excess imports, the buyers of foreign goods will purchase part of the country's international reserves with domestic currency, and then send the hard currency abroad. The domestic money supply will decline simultaneously with the country's foreign reserves (IR falls and, consequently,  $M^s$  declines).

The balance of payments deficit will be eliminated only when the domestic money supply returns to its initial level – but the supply of money will have a different composition, with a higher share of DC and a lower share of IR because of the decline in the country's net foreign assets.

In this model, inflation and balance of payments deficits can persist *only* if DC rises period after period. In this case, the tendency towards a return to equilibrium (explained in the previous paragraphs) will be unable to assert itself. The economy will face permanent inflation and a continuing balance of payments deficit, potentially leading to the exhaustion of the country's foreign currency reserves. The only agent that can increase DC at will is *the government*. In other words, a persistent fiscal deficit, if monetised by accommodating monetary policy, will generate both inflation and a balance of payments deficit simultaneously. Reciprocally, whenever a country faces persistent inflation and balance of payments deficits, this must be due to excess domestic absorption created by a fiscal deficit and an accommodating monetary policy. Even if, for some reason, a large fiscal deficit is not immediately evident, contractionary monetary and fiscal policies will help to eliminate both inflation and the balance of payments deficit at the same time.

Three implications follow from this analysis:

- Inflation and balance of payments deficits are caused by macroeconomic mismanagement.
- Governments should limit domestic credit creation (and, therefore, monetary policy accommodation) to levels compatible with inflation stability and balance of payments equilibrium.
- This policy adjustment has no lasting impact on real output and income.

These conclusions hold only if the initial assumptions are valid – that is, if markets work smoothly, if the economy is fully competitive, if the QTM holds, if fiscal deficits are the main cause of inflation, if monetary policy is unduly accommodating, and if the level of employment is always high. If one or more of these assumptions are invalid, the FP model may fail to provide reliable guidance for economic policy-making.

The analytical insights offered by the FP model have been used to justify and support IMF stabilisation programmes, including three of their key elements, namely, **import liberalisation**, **currency devaluation** and a set of **macroeconomic policy reforms**. These programmes have been justified as the means to impose both domestic and external equilibrium in the economy – specifically, intertemporal fiscal balance, low inflation and balance of payments stability.

It is claimed that import liberalisation will increase competition in the domestic market, raise the productivity of capital and labour and foster trade specialisation according to the country's comparative advantages. Therefore, it will raise economic flexibility and efficiency (in contrast,

macroeconomic disequilibria are normally associated, in the orthodox literature, with strategies of import substitution). Devaluation of the currency should contain import demand despite the liberalisation of trade, while also reducing production costs in dollar terms (especially domestic wages, which are usually the most important component of production costs) and raising the profits of the export sector, thus supporting the economic shift towards the production of goods in which the country has a comparative advantage. Finally, macroeconomic reforms will expand and consolidate these economic changes. They normally include, among other elements:

- a) Fiscal and monetary policy discipline, making it possible to cut down the government deficit, control inflation and reduce the scope for government intervention in the economy. This includes tax increases, public spending cuts, higher interest rates and privatisations.
- b) Shift of government spending away from capital investment and direct economic intervention, and towards the provision of public goods, especially health and education.
- c) Economic deregulation, to allow the price system to signal correctly relative scarcities and consumer preferences.
- d) Domestic financial liberalisation, so as to raise real interest rates, stimulate savings and raise the returns on investment.
- e) Labour market reforms to increase flexibility and raise productivity. Such reforms include changes in hiring and firing rules, decentralising labour relations, curtailing trade union rights, eliminating collective agreements and protective regulation, and reducing social security benefits.
- f) Liberalisation of the capital account of the balance of payments, so as to attract foreign savings, improve the balance of payments, absorb foreign technology and facilitate access to foreign markets.
- g) Legal reforms, primarily intended to increase property rights protection.

These reforms may be supplemented, at a later stage, by limited debt relief (the important case of the IMF-World Bank Highly Indebted Poor Country (HIPC) initiative is examined in Box 2). In the long-run, the IMF and the World Bank aim to make these policy reforms *irreversible* through the transfer of 'policy ownership' to the local governments (i.e., ensuring permanent compliance with the imperatives of creditors and international financial organisations).

The policy changes associated with stabilisation and structural adjustment programmes tend to produce a recession in the short-run, since domestic demand inevitably falls because of the reductions in wages and government expenditure, and because of higher interest rates and import prices resulting from the devaluation of national currency. However, since orthodox economic theory presumes that markets work, it is claimed that any such recession will be short-lived (it should last no more than 18-24 months). After this transition period, the economy should reach a new equilibrium with greater efficiency and higher output. Unfortunately, this does not normally happen, as IMF programmes often lead to chronic economic underperformance.<sup>13</sup>

## BOX 2

**The Washington Consensus and the HIPC Initiative**

The failure of most countries to achieve the desirable outcomes expected by the mainstream stabilisation and structural adjustment strategies associated with the IMF, the World Bank and the U.S. Treasury Department (the 'Washington consensus') has led to insistent calls for modification of the conditionality framework associated with these macroeconomic programmes. In the mid- and late 1990s, such criticism contributed to the development of the 'post-Washington consensus', associated with Joseph Stiglitz (see Fine, Lapavistas and Pincus 2001). The criticism also led to significant modifications of the mainstream approach itself, especially through the HIPC initiative.

HIPC-1 was launched by the World Bank and the IMF in 1996. Its main objectives were to provide assistance to developing countries following 'sound' economic policies, in order to help them reduce their debt burden to a sustainable level. HIPC-1 focused not only on debt relief, but also on channelling additional finance to the so-called pro-poor sectors, especially basic health, education, agriculture and water. Countries would qualify depending on two criteria: their debt burden and their track record of reform and 'sound' policies as monitored by the IMF and the World Bank. HIPC-1 was later abandoned, because it was perceived to involve excess conditionality, and too much time was needed before countries would qualify for debt relief. HIPC-1 was reviewed in 1999, and HIPC-2 was introduced. This new initiative aims to provide faster debt relief and to link debt relief and poverty reduction more strongly, through pro-poor economic policies. However, this debt-relief programme remains wedded to essentially the same macroeconomic approach associated with the FP model, whose shortcomings have already become obvious in the experience of many countries.

It was important to strengthen HIPC-2 and similar initiatives to reduce the debt burden of the poorest countries. Unfortunately, it has become clear that HIPC-2, as it currently stands, does not offer the level of debt relief and support to pro-poor initiatives that is needed in order to enable the achievement of the MDGs and other pro-poor goals (see Buira 2003 and Unctad 2002, ch.5). In order to achieve these goals, it will be necessary to shift the focus of economic policy from contractionary monetary and fiscal policies, stabilisation and debt repayment, towards pro-poor economic policies emphasising growth and the reduction of poverty.

**READINGS**

Buira, A. (2003). 'An Analysis of IMF Conditionality', G-24 Discussion Paper no.22, G-24 website.

Fine, B. (2005). 'Financial Programming and the IMF', in Jomo K.S. and B. Fine (eds.), *The New Development Economics: After the Washington Consensus*. London: Zed Books and New Delhi: Tulika Books.

McKinley, T. (ed.) (2001). 'Introduction', in *Macroeconomic Policy, Growth and Poverty Reduction*. London: Palgrave.

McKinley, T. (2005a). 'MDG-Based PRSPs Need More Ambitious Economic Policies', UNDP Discussion Paper, New York, January.

Milanovic, B. (2003). 'The Two Faces of Globalization: Against Globalization as We Know It', *World Development* 31 (4), pp. 667–683.

Tarp, F. (1993). *Stabilisation and Structural Adjustment: Macroeconomic Frameworks for Analysing the Crisis in Sub-Saharan Africa*. London: Routledge.

Unctad (2002). *The Least Developed Countries Report*. New York: Unctad.

### 3 PRO-POOR MONETARY POLICY

Monetary policy can contribute to the success of a pro-poor development strategy in four different ways:

- Supporting the pro-poor fiscal policies outlined in Training Module #1.
- Avoiding excessively low, excessively high or rapidly accelerating inflation.
- Helping to stabilise the balance of payments and the real exchange rate.
- Supporting the improvement of resource allocation in the economy by providing targeted credit to priority sectors and effectively managing the country's capital controls.

These principles are discussed in section 3.1. Section 3.2 reviews pro-poor financial policy. Section 3.3 examines the costs of inflation, and section 3.4 surveys the distributive implications of inflation.

#### 3.1 MONETARY AND BALANCE OF PAYMENTS POLICY

Orthodox monetary policies tend to saddle interest rates with the potentially conflicting roles of **(a) balancing savings and investment**, **(b) controlling inflation** (i.e., managing the level of economic activity) and **(c) achieving balance of payments equilibrium**. However, if interest rates have to fulfil these three roles simultaneously, they will tend to be permanently high, because they cannot fall below the highest of these three levels. If they do, within the orthodox framework, savings will be insufficient to fund the desired investment projects, inflation will start to climb, or the balance of payments will slide into a deficit. All of these scenarios have negative implications for financial stability, investment, employment generation, distribution and growth. In addition to this, the literature has shown that high interest rates are associated with regressive distributive shifts, financial market bubbles and financial and balance of payments crises (see section 3.4).<sup>14</sup>

Pro-poor development strategies should avoid these regressive outcomes. The manipulation of interest rates in pro-poor strategies should aim *primarily* at securing financial and money market equilibrium. In these markets, the manipulation of interest rates should be supplemented by other instruments, especially the provision of **targeted credit** to offer incentives for investment in pro-poor sectors or in those sectors deemed to be socially important or generating valuable externalities (see section 3.2).

Since interest rates influence investment and savings and, therefore, aggregate demand, monetary policy must indeed play an important role in inflation control. However, this should not be the main priority of monetary policy (see section 4.3). Interest rates should be used to control aggregate demand and the level of activity only exceptionally, namely, if macroeconomic stability is significantly impaired. Under normal circumstances, fiscal policy should be the main policy responsible for regulating the level and structure of demand. If the interest rates are not burdened with this task, then they can be lower and more growth-accommodating. This will support the expansion of investment and reduce the service burden of the domestic public debt. This will also make additional public and private resources available for pro-poor objectives.<sup>15</sup>

For similar reasons, interest rates should not play a key role in securing balance of payments equilibrium. A pro-poor development programme requires a specific strategy for the balance of payments, comprising policies for export promotion, discrimination of imports and

regulation of foreign investment and transfers, including aid. From a pro-poor viewpoint, the determinants of these flows are too subtle to be successfully addressed merely through the manipulation of interest rates.

One of the most important aspects of a pro-poor development strategy for the balance of payments is the **control of capital flows**. To put it bluntly, it is *impossible* to implement a pro-poor development strategy with an open capital account of the balance of payments. Capital controls will help to secure balance of payments stability while freeing up interest rates to pursue pro-poor and developmental goals. Unbridled liberalisation of the capital account is destabilising for five reasons. First, it promotes speculative inflows that can finance consumption rather than investment, while also fostering the accumulation of foreign debt, especially by the banks. By the same token, capital account liberalisation facilitates capital flight and increases the country's vulnerability to balance of payments crises. Second, pro-poor development strategies require monetary policy autonomy. For example, they may require lower interest rates than those compatible with balance of payments equilibrium under a regime of free capital flows. Capital account liberalisation eliminates the possibility of achieving those interest rates and, therefore, it should be avoided. Third, pro-poor strategies require the state to direct investment and other resource flows to growth-promoting and poverty-reducing goals, which may conflict with the short-term interests of the financial sector. If the economy is permanently threatened by capital flight and balance of payments crises, it will become impossible to implement an effective macroeconomic strategy. Fourth, foreign investment can dislocate private investment in potentially profitable areas while, at the same time, being less amenable to state direction than domestic investment. Fifth, and more prosaically, capital controls will help to curb tax evasion, since the tax rates required to fund pro-poor programmes could be higher than those prevailing elsewhere, especially in tax havens. In addition to this, capital controls can help aid-dependent countries to effectively manage their exchange rate, especially if their financial markets are insufficiently developed, as is often the case in sub-Saharan Africa.

Several forms of capital controls have been used recently by such diverse countries as Chile, Japan, Malaysia, Republic of Korea and Sweden.<sup>16</sup> In these countries,

The use of controls has not resulted in interruptions of economic growth; on the contrary, when controls have been removed, as in Mexico in the early 1990s and in East Asia in the late 1990s, financial crises and severe economic downturns have been the result. Capital controls are not a fixed set of policies, and there are several different ways in which the flow of funds in and out of a country can be regulated ... Whatever form they take, **controls over the movement of funds across a country's borders are a necessary part of any general program of economic change**; without such controls, a government cedes the regulation of its economy to international market forces, which often mean the forces of large internationally-operating firms and powerful governments of other countries.<sup>17</sup>

Capital controls can include, for example, restrictions on foreign currency bank accounts and currency transfers; taxes or administrative limits on outflows of direct and portfolio investment; restrictions on foreign payments for 'technical assistance' between connected firms; controls on foreign borrowing; non-interest bearing 'quarantines' on foreign capital inflows, when they are temporarily deposited at the central bank earning zero interest in order to create disincentives for short-term speculative transactions; and multiple exchange rates determined by the relative priority of each type of resource flow. Managing these controls will certainly burden the monetary authorities, but experience shows that this task is not beyond the capabilities of most central banks. The most significant obstacle to the introduction of capital controls is not technical – it is *political*.



## READINGS

Agosin, M. R. and Tussie, D. (eds.) (1993). *Trade and Growth: New Dilemmas in Trade Policy*. London: Macmillan.

Argitis, G. and Pitelis, C. (2001). 'Monetary Policy and the Distribution of Income: Evidence for the United States and the United Kingdom', *Journal of Post Keynesian Economics* 23 (4), pp.617-638.

Chang, H.-J. (1994). *The Political Economy of Industrial Policy*. London: Macmillan.

Chang, H.-J. and Grabel, I. (2004). *Reclaiming Development: An Alternative Economic Policy Manual*. London: Zed Books.

Epstein, G., Grabel, I. and Jomo K. S. (2003). 'Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future'. G-24 Discussion Paper, G-24 website.

Gereffi, G. and Wyman, D. L. (eds.) (1990). *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia*. Princeton: Princeton University Press.

Kaplan, E. and Rodrik, D. (2000). 'Did the Malaysian Capital Controls Work?', Internet.

MacEwan, A. (2003). 'Debt and Democracy: Can Heavily Indebted Countries Pursue Democratic Economic Programs?' Paper presented at the symposium 'Common Defense Against Neoliberalism', Istanbul.

Roy, R. and Weeks, J. (2003). *Thematic Summary Report: Fiscal Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.

### 3.2 PRO-POOR MONETARY AND FINANCIAL POLICY

Financial policy is a subset of monetary policy. It can affect poverty in two principal ways. The first is directly, through its impact upon productive activity and, therefore, on income and employment generation and on income and asset distribution. The second is indirectly, through its effect on the stance of the government's fiscal and monetary policies. These, in turn, impact upon employment and output growth, and on social-sector and poverty-reducing public expenditures. For further discussion of financial policies, see Training Module #3.

Conventionally, the study of financial policy for development focuses on its capacity to mobilise resources, expand resource availability over time, and help to address the balance of payments or other constraints to growth.<sup>18</sup> In this framework, if the financial sector is left unregulated (in what is called a market-based financial system),<sup>19</sup> market signals would determine the allocation of investible resources and, therefore, the demand for and allocation of savings intermediated by financial enterprises. This could result in problems when private rather than social returns determine the allocation of savings and investment. An obvious way in which this happens is through inadequate investment in infrastructure, which is often characterised by lumpy investments, long gestation lags, higher risk and lower profit rates. Given the externalities associated with such activities, inadequate investments in infrastructure would constrain the rate of economic growth. This could aggravate the tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, speculation, or to concentrate funds in the hands of a few large players and direct savings to already developed centres of economic activity. This

would worsen income distribution and dampen the pace of poverty reduction. In order to influence the allocation and cost of investment, support poverty reduction and redistribute incomes and assets, it is essential for the government to regulate the financial sector (see section 3.1).

The direct effects of these financial sector policies on growth, employment and poverty can be mediated in different ways. They include the cost and other conditions for access to credit, the level and pattern of private investment, and the cost of financing public sector deficits. If the economy is characterised by segmented markets, we could also expect to see a hierarchy of rates of return. For example, big capital with access to areas offering higher returns may not be willing to enter areas offering lower returns, while medium and small capital may be unable to make investments because of inadequate access to credit. In this case, certain markets may be inadequately serviced by private investors. The cost of credit could also affect growth by influencing the choice of products and technologies in a manner that would impact the elasticity of employment with respect to output. Financial policies can also adversely affect poverty reduction if they fail to address the lack of credit to structurally disadvantaged sectors such as agriculture, the urban small-scale sector, and rural non-agricultural activities, which are important from the point of view of poverty reduction.

Orthodox policies of financial liberalisation often lead to financial growth and deepening [poverty], and to a greater importance of financial agents in the economy. But this almost invariably compels the state to adopt a contractionary monetary policy stance, in order to appease those interests. Financial agents are normally against state deficit spending for several reasons. First, deficit financing is seen to increase the liquidity overhang in the system, and therefore to be potentially inflationary (see section 2.2). Second, since government spending is 'autonomous' in character, according to orthodox policies, the use of debt to finance such spending introduces into financial markets an arbitrary player not driven by the profit motive, whose activities can render the interest rate differentials that determine financial profits more unpredictable. Third, if deficit spending leads to a substantial build-up of the state's debt and interest burden, then the state may decide to intervene in financial markets to lower interest rates or restructure the stock of public sector debt, with adverse implications for financial returns.

Liberalisation also tends to increase the fragility of the financial sector and the likelihood of financial bankruptcy, thus rendering the financial system more prone to large-scale crises. These features create a deflationary environment and can have negative consequences for poverty reduction. In fact, the experience of some Asian countries suggests that, despite efforts to use new means to continue with directed credit (as in Vietnam) or to rely on new institutions such as micro-finance enterprises to bring credit to vulnerable households, financial liberalisation has reduced the prospects of pro-poor growth, without contributing very much in the form of improved allocative efficiency. This suggests that liberalising the domestic financial sector and easing cross-border flows of capital are not the best options for countries with significant problems of poverty and lack of economic diversification.

In order to enforce pro-poor monetary and financial policies, the state would have to choose an appropriate institutional framework and regulatory structure for the financial sector. Central to such a policy framework in low- and middle-income countries are policies aimed at fostering bank credit for selected sectors like agriculture and small-scale industry. In India, for example, the government specified that a certain proportion of lending should be directed to these sectors. Directed credit programmes were often accompanied by differential interest rate policies that ensured demand for credit from these sectors by cheapening the cost of credit. The central bank in many instances requires that part of the banking system deposits be held in the form of specified

securities, including government securities. This ensures that banks are forced to make a certain volume of investment in debt issued by government agencies. Such debt can be used to finance expenditures warranted by the overall development strategy of the government, including its poverty alleviation component.

Another important financial intervention adopted by several successful low- and middle-income countries is the creation of development banks with the mandate to provide cheap – or subsidised – credit to selected industrial establishments and the agricultural sector. The principal motivation for the creation of such financial institutions is to make up for the failure of private financial agents to provide certain kinds of credit to specified kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not profitable. In other instances, failure may be due to the unwillingness of financial agents to take on certain kinds of risk or to the fact that anticipated returns to private agents are much lower than the social returns in the investment concerned.

Industrial development banks also help deal with the fact that local industrialists may not have adequate capital to invest in capacity of the required scale in more capital-intensive industries characterised by significant economies of scale (as was the case, historically, in Brazil and Chile). Similarly, agricultural development banks can advance subsidised credit to the agricultural sector, in particular to small and marginal farmers without the means to undertake much-needed investments. Given their low credit rating, these farmers are excluded from the normal lending programmes of commercial banks and are thus forced to rely on informal sources such as moneylenders, landlords and traders, at interest rates that far exceed those charged by commercial banks. Finally, directed credit can have positive fiscal consequences. In contrast to subsidies, such credit reduces the demand placed on the government's own revenues. This makes directed credit an advantageous option in poor countries faced with chronic budgetary difficulties.

In sum, in following a pro-poor development strategy, the state should not only play the role of an investment coordinator, but also use monetary policy and the financial system to direct investment to sectors and technologies that it considers appropriate. Directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory, especially if it is pro-poor and pro-growth. Put differently, even if financial policies do not directly help increase the rate of savings and ensure that the available *ex ante* savings are invested, they can no doubt be used to influence the pattern of investment.

## READINGS

Aybar, S. and Lapavitsas, C. (2001). 'Financial System Design and the Post-Washington Consensus', in B. Fine, C. Lapavitsas and J. Pincus (eds.), *Development Policy in the Twenty-first Century: Beyond the Post-Washington Consensus*. London: Routledge.

Chandrasekhar, C. P. (2004). *Thematic Summary Report: Financial Liberalisation*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.

Demigurç-Kunt, A. and Levine, R. (1999). 'Bank-Based and Market-Based Financial Systems: Cross-Country Comparisons', manuscript, internet.

Levine, R. (1997). 'Financial Development and Economic Growth: Views and Agenda', *Journal of Economic Literature* 35, pp.688-726.

Roy, R. and Weeks, J. (2003). *Thematic Summary Report: Fiscal Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.

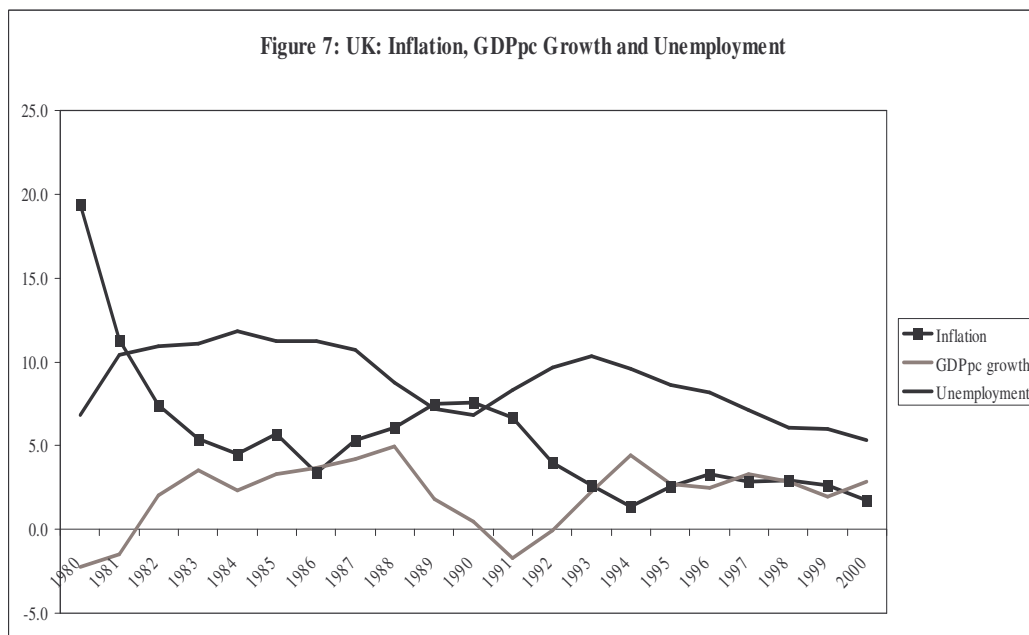
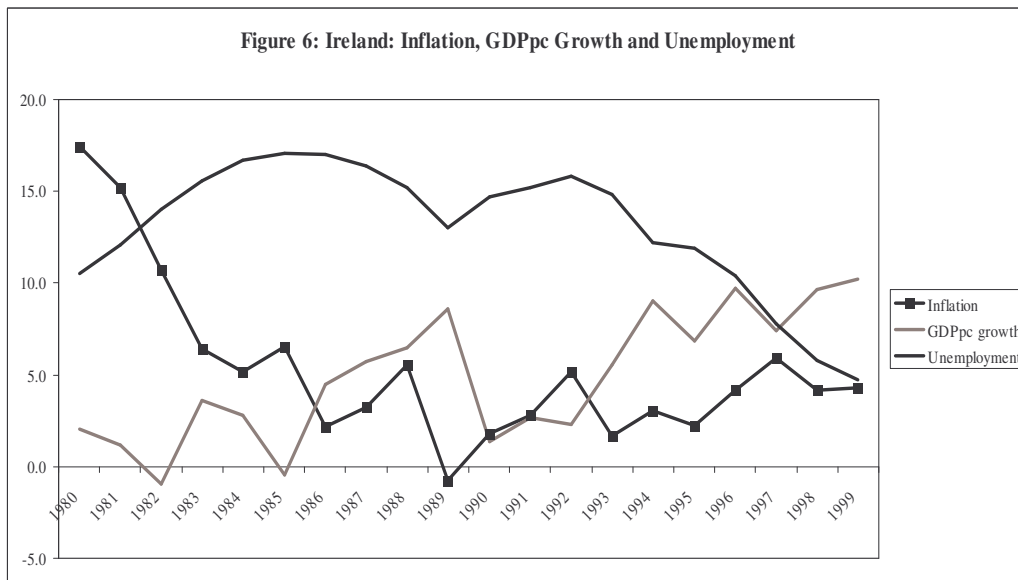
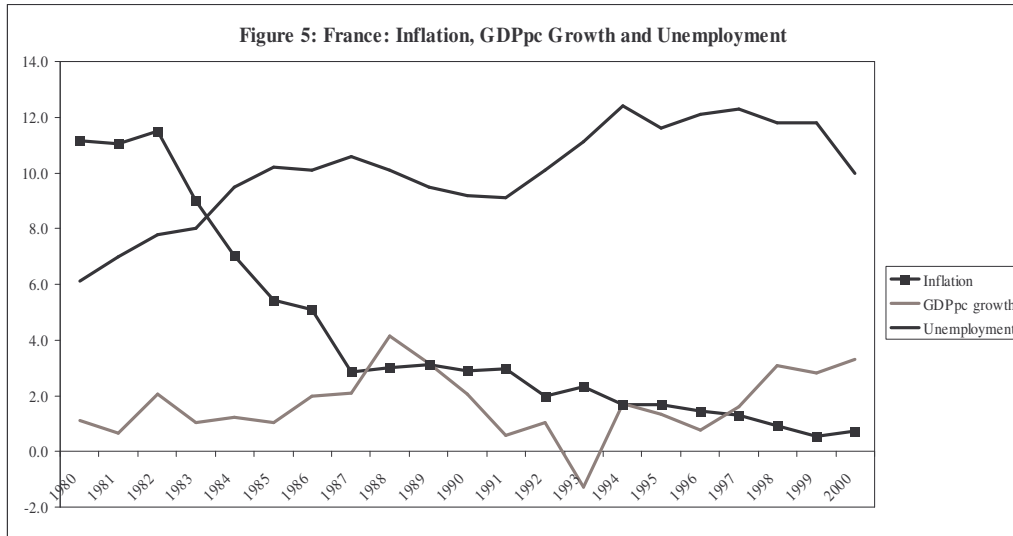
Zysman, J. (1983). *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change*. Oxford: Martin Robertson.

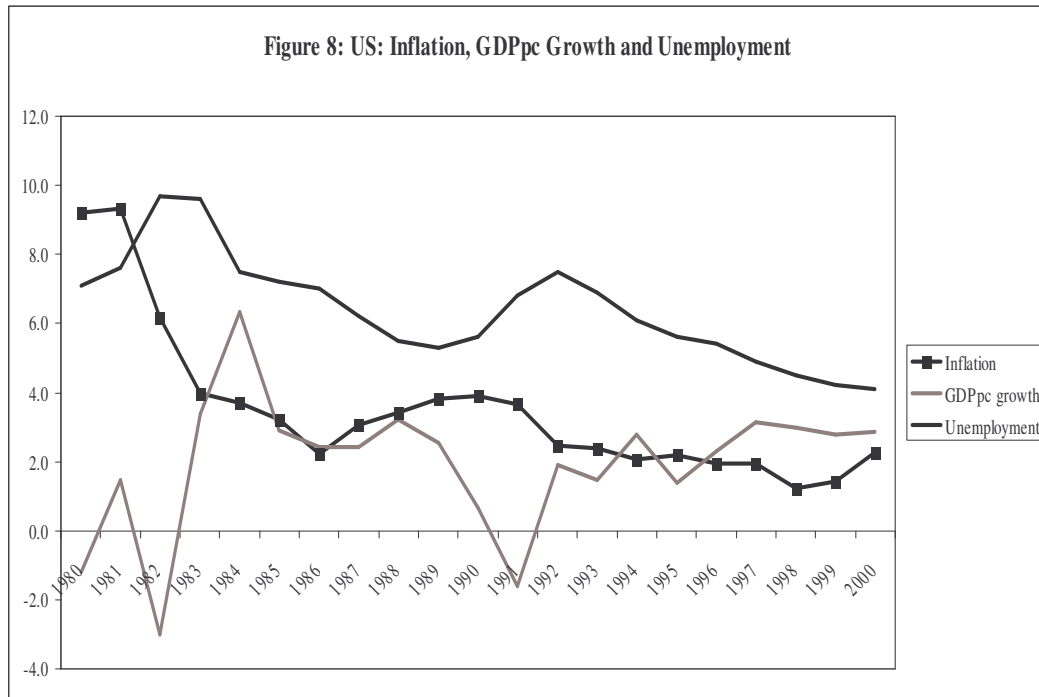
### 3.3 INFLATION AND THE COSTS OF INFLATION

Orthodox theory claims that inflation control (rather than growth, employment or distribution) should be the most important objective of monetary policy, because low inflation allegedly helps to improve resource allocation and fosters market development, private investment and rapid and stable economic growth (see section 2.1). In other words, in orthodox theory there is a trade-off between inflation and growth (or, alternatively, between inflation and unemployment, since there is a high negative correlation between unemployment and growth). As shown previously in this text, the orthodoxy also argues that inflation is due primarily to monetary factors, especially the monetisation of fiscal deficits. Low inflation should be achieved mainly through aggregate demand control – which, in turn, is achieved by means of contractionary monetary and fiscal policies and by manipulating interest rates. These policies should be supported by privatisations, trade, financial and capital account liberalisation, and other macroeconomic policy reforms aiming to consolidate a specific (orthodox) development strategy (see section 2.2).

There is no question that contractionary monetary and fiscal policy can help to reduce inflation, whatever its causes. However, this strategy is rarely compatible with sustained growth, macroeconomic stability or the achievement of pro-poor outcomes. Contractionary policies frequently stifle growth, transfer income to the financial sector and the rich, and tend to conflict with the goals of pro-poor fiscal policy, increasing its costs and, possibly, even rendering it ineffective.

The orthodox approach is inadequate for other reasons too. To begin with – and this is of critical importance for policy debates – there is no conclusive evidence of a stable trade-off between inflation, growth and unemployment.<sup>20</sup> While there is, for obvious reasons, a clear negative relationship between growth and unemployment, they seem to move independently of inflation. A clear example of this lack of correlation is given by data from four developed countries, namely, France, Ireland, the U.K. and the U.S.A., for the period between 1980 and 2000 (see figures 5-8). These countries were chosen because of their economic importance (especially the U.S.A., the U.K. and France), and because of their remarkable growth performance in recent years (Ireland). This is obviously not an exhaustive sample of country case studies, but it serves to illustrate the argument that the orthodox claim that inflation and growth are closely correlated is exaggerated and possibly misleading.

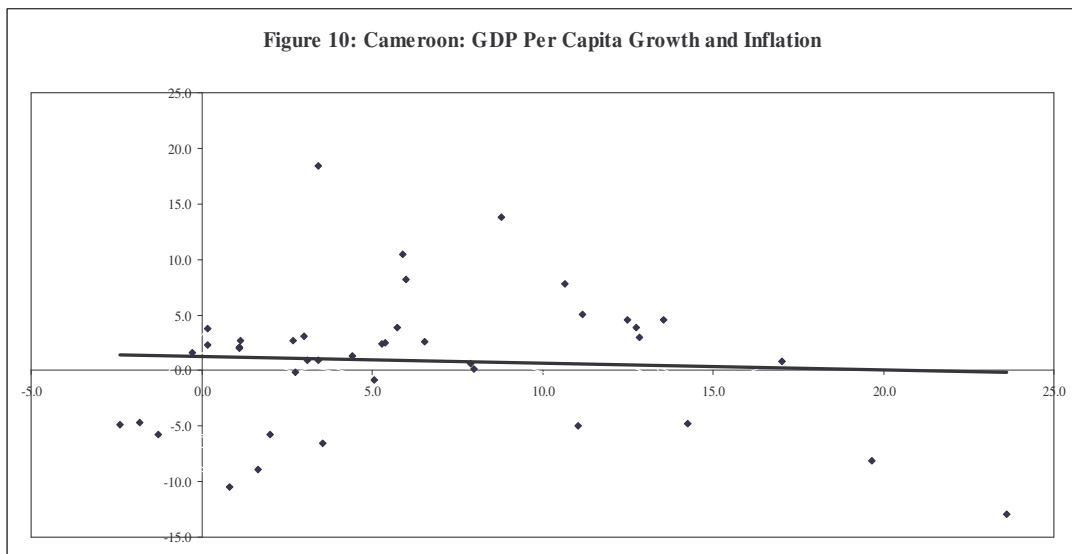
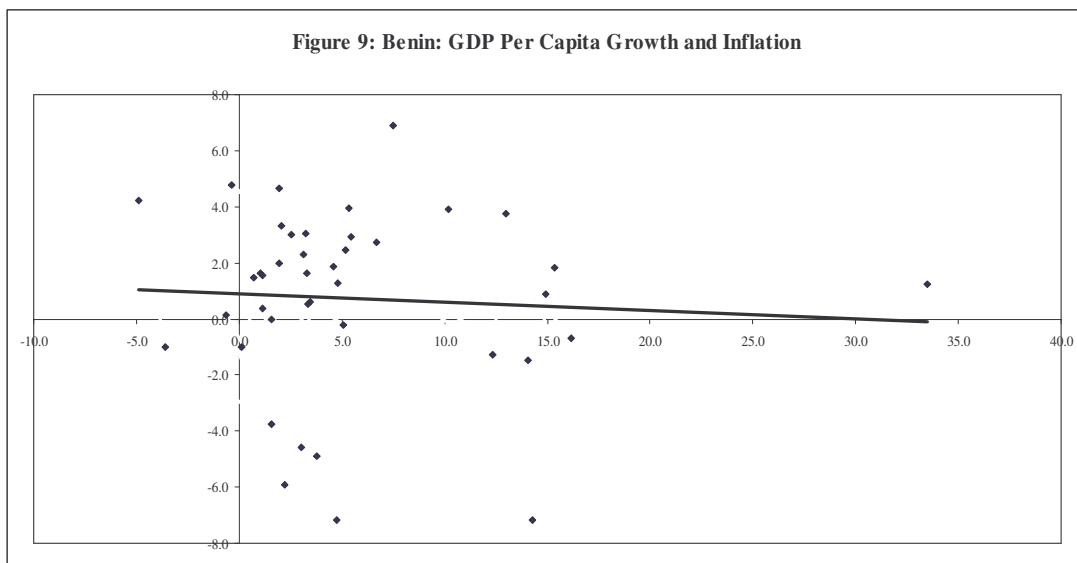


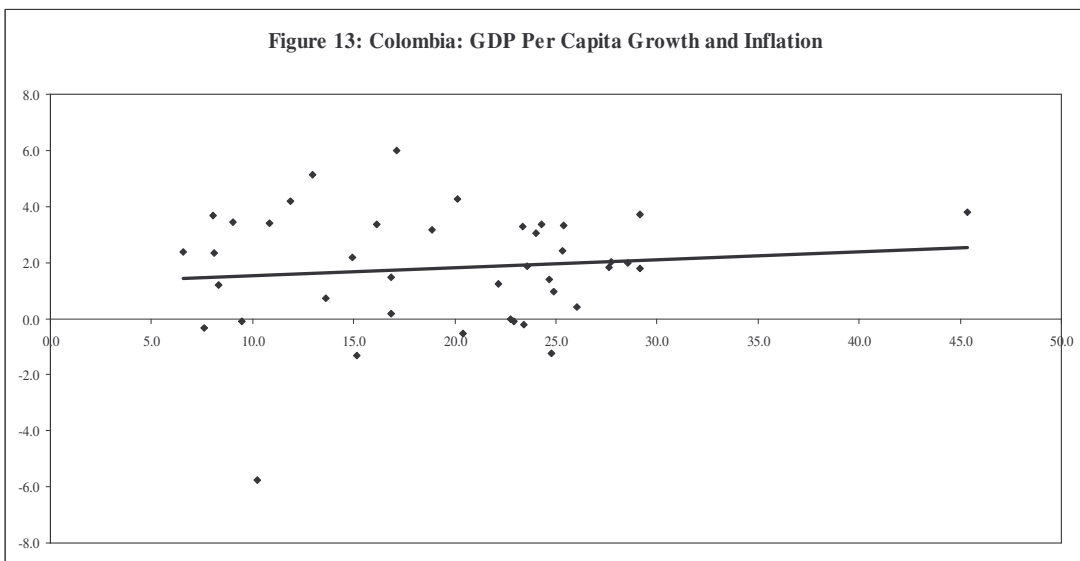
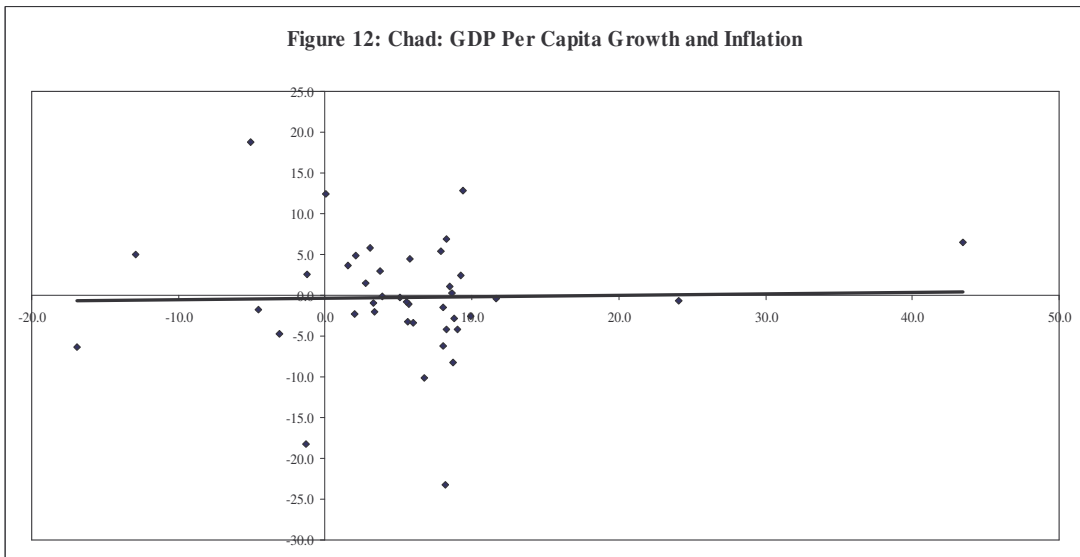
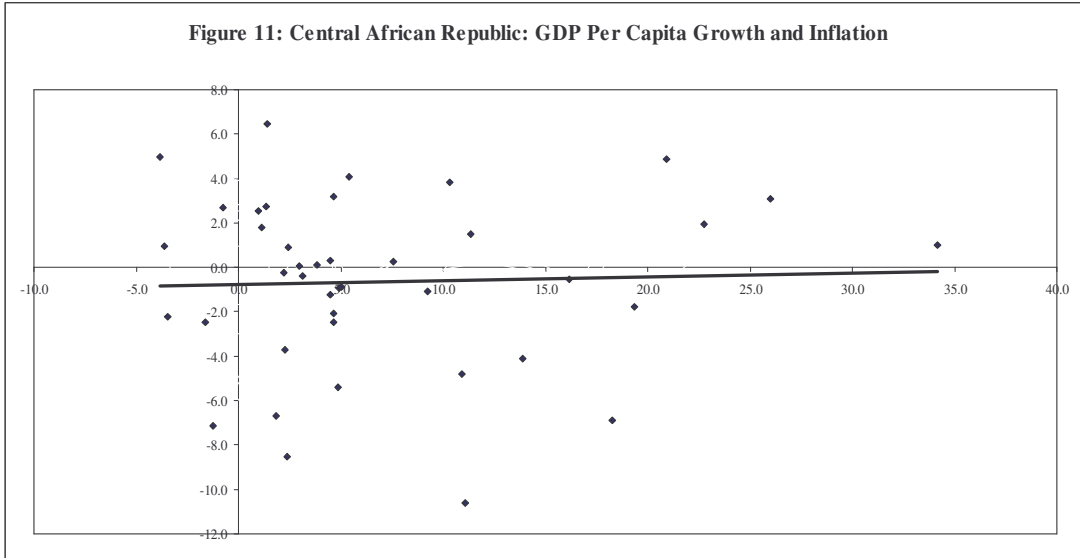


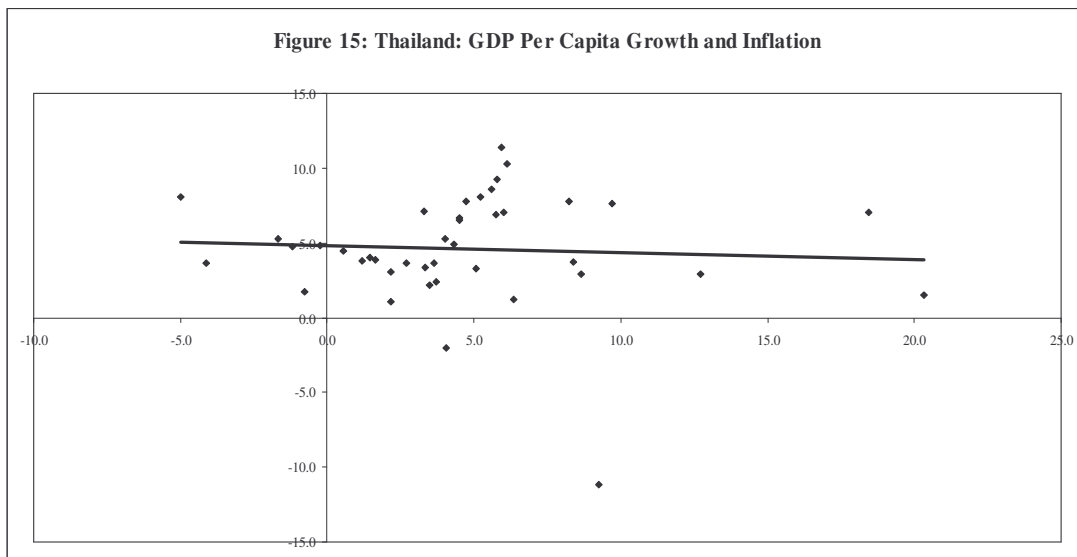
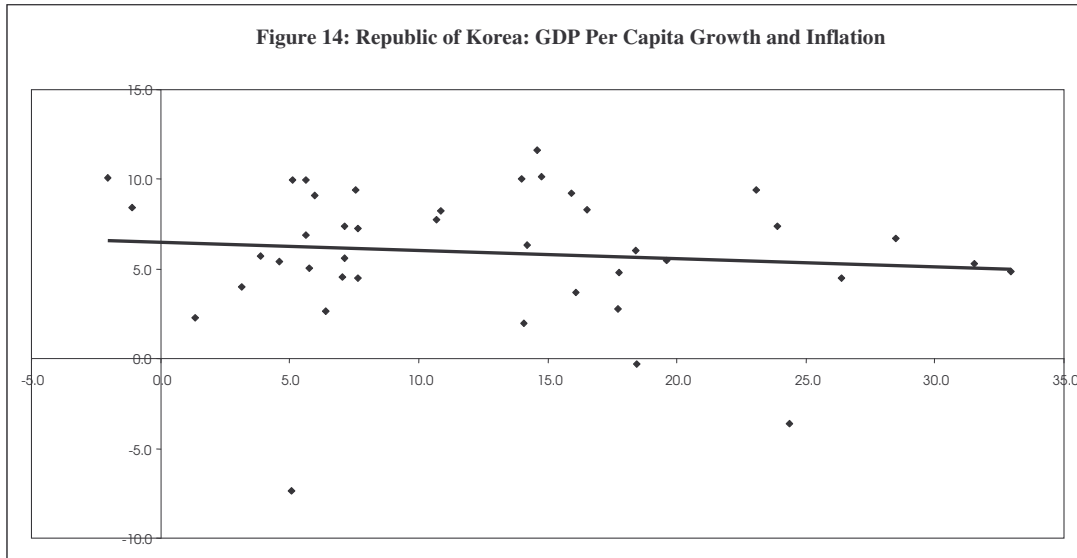
- In France, per capita GDP growth was low during the entire sample period, especially in the early 1990s. Slow growth probably contributed to the steady rise of unemployment until 1994. Unemployment began to fall only later in the 1990s, as growth rates picked up. In contrast, the rate of inflation declined slowly during the entire period, as the French government implemented stringent fiscal and monetary policies. The lack of correlation between inflation and growth rates during the sample period is evident on inspection.
- In Ireland, the per capita GDP growth rate increased regularly across the sample period, reaching an extraordinarily high 10 per cent per annum towards the end of the period. Unemployment, starting from a relatively high base, peaked at 17.1 per cent in the mid-1980s, but began to decline in the early 1990s, to reach 4.7 per cent in 2000. This trajectory, as expected, was primarily a response to the high GDP growth rates recorded during that period. In contrast, inflation assumed a falling trend until 1989, then increased slightly but only touched above five per cent in 1998. Once again, no systematic relationship between inflation and growth is apparent.
- In the U.K., economic growth was relatively strong and stable during the 1980s and since the mid-1990s, after the recession of 1990-91 and the devaluation of the sterling, in 1992. However, unemployment responded only slowly. In contrast, inflation tumbled in the early 1980s and, again (after a temporary increase), in the early 1990s. Inflation has been stable well below five per cent since 1992.
- Economic growth in the U.S.A. was stronger than in the U.K., although it showed a similar pattern, with low or negative growth in the early 1980s and a significant dip around 1991. Unemployment reacted more strongly than in Britain, and declined steadily after the early 1990s. In contrast, inflation fell in the early 1980s and has been under control ever since.



Several low-income countries had similar experiences (unemployment data cannot be considered in this case, because they are much less reliable than for rich countries). For example, there is *no* significant relationship between inflation and growth in such randomly selected low-income countries as Benin, Cameroon, Central African Republic and Chad, or in middle-income countries such as Colombia, the Republic of Korea and Thailand. Figures 9-15 show the relationships between GDP per capita growth (measured on the vertical axis) and inflation (on the horizontal axis) for these seven countries. The trend lines are approximately horizontal in most cases, showing the lack of any relationship between these variables. Even where such relationships seem to exist (i.e., the trend lines are either positively or negatively inclined), the inclination varies both in direction and slope, indicating that relationships between growth and inflation, if any, depend on both the country and the context.







If there is a trade-off between inflation and growth, it must be both elusive and unstable, as shown by the figures above for both rich and poor countries, and reinforced by the conflicting views in the literature and by the frequently changing estimates of the 'equilibrium' rate of unemployment – in those countries where such estimates are available. Orthodox studies often generalise on the basis of a small number of cases of extremely high inflation, when simultaneously growth was compromised and the resumption of growth coincided with the elimination of high inflation.<sup>21</sup> There is no question that hyperinflation is bad for macroeconomic performance; in these cases, stabilisation can, in fact, become a necessary condition for output and productivity growth. However, high inflation and low growth rates could be mere *symptoms* of other economic problems and processes. Examples are the transition to capitalism in former socialist economies, social conflicts and fiscal and financial sector dysfunctions in Latin America, supply constraints and civil strife in many high-inflation sub-Saharan African countries, and balance of payments problems in Middle Eastern and North African countries. In cases such as these, inflation stabilisation may not be conducive, in and of itself, to the resumption of growth.

It is likely that a general trade-off between inflation and growth (or between inflation and unemployment) is non-existent, since economies are known to grow rapidly for long periods – even decades – with stable or falling unemployment and moderate (non-accelerating) inflation.<sup>22</sup> Therefore, the trade-off between inflation and growth cannot simply be assumed to exist. The relationship between these variables, if any, is likely to depend on the structural and institutional development of the economy, the stage of the economic cycle and the state's economic policies. Any presumed trade-off has to be shown to exist (or not) for each economy, and in each phase of development. It would be misguided to design economic policies under the assumption that there is a stable and universally valid trade-off between inflation and growth, since none may be present.

The orthodox case for the superiority of price stability can also be questioned on the basis of estimates of this presumed trade-off. For example, Forder (2003, p.14) reports that holding the U.S. unemployment rate one per cent below the non-accelerating inflation rate of unemployment (NAIRU) for a year would result in an increase in inflation of only 0.3 per cent (see Box 3). Alternatively, suppose for the sake of argument that Milton Friedman is right, and that it takes several years for expected inflation to catch up with real conditions. If a country adopts a policy of gradually raising inflation over 30 years, and manages to keep unemployment two per cent below its natural rate during the entire period,

[W]e can perform a thoroughly back-of-the-envelope cost-benefit calculation. Over the 30 year period, the total of output in excess of the natural level will be about 60% of one year's GDP. At a rate of return of 5%, that extra output, if invested, is worth 3% of GDP per year in perpetuity. On the cost side we have an equilibrium rate of inflation of 10%. The question, therefore, is whether we would think such an increment in income is worth the price of the inflation.<sup>23</sup>

Finally, suppose that there is a natural rate of unemployment (which is, of course, questionable) but this rate is unknown at any point in time. In this case, it may be worthwhile to adopt a policy of 'cautious expansionism', testing the limits of growth even at some risk of increasing inflation, especially if the cost of inflation and the risk of a relentless acceleration towards hyperinflation are not very high.<sup>24</sup>

**None of these arguments indicates that inflation is 'good'.** Rather, they highlight the fact that there may be choices to be made about the priority and intensity to be given to inflation control. These are not simply 'technical' issues, and the benefits of very low inflation do not necessarily trump every conceivable alternative, every time.

Deeper and more careful studies of the relationship between inflation and growth seem to indicate that this relationship, if it exists at all, is non-linear: both very low and very high inflation may be associated with poor growth performance, but empirical assessments of **moderate inflation** (around 10-40 per cent) show that it **is not correlated with low or falling GDP growth rates, low or falling investment (including both domestic and foreign investment), high or rising unemployment, or a deteriorating distribution of income or rising poverty. And it does not tend to accelerate.**<sup>25</sup> It is even possible that moderate inflation may help to *sustain* economic growth, especially when there is excess capacity and significant unemployment or underemployment. There is evidence that moderate inflation is associated with *higher* incomes for the poorest, and monetary contraction with a *worsening* of the relative position of the poor.<sup>26</sup> In fact, these studies suggest that **excessively low inflation can be bad for growth**, especially if prices and wages are sticky downwards.

In sum, it seems, first, that ***the relationship between inflation and growth*** – if it does exist – ***is likely to be non-linear***. Second, ***the optimal rate of inflation can change*** in space and over time, and it may even be positively correlated with the rate of economic growth. Third, even though high inflation can harm the poor, ***excessively low inflation and conventional stabilisation policies can have the same result***.<sup>27</sup>

## BOX 3

**The NAIRU and the NRU**

The NAIRU (non-accelerating inflation rate of unemployment) derives from the monetarist concept of the 'natural rate of unemployment' (NRU). The NRU is the unemployment rate at which all markets, including the labour market, are in equilibrium. Labour market equilibrium does not imply that everyone has got a job: the NRU includes frictional unemployment and regular movements of entry into and exit from the labour market, including job searching. For the monetarists, if unemployment is equal to the NRU the economy is, in practice, operating at 'full employment'. Higher levels of unemployment are normally associated with labour market rigidities, for example, high minimum wages or strong trade union activity. In contrast, unemployment below the NRU indicates that the labour market is 'tight' – there is excess demand for labour, perhaps because fiscal policy is unduly expansionary, which tends to generate inflation because of the workers' escalating wage demands. The NAIRU builds on this interpretation of the relationship between the labour market and the price level. The NAIRU is defined as the unemployment rate compatible with stable inflation in the long run (if the economy is operating below the NAIRU, inflation will presumably accelerate and vice-versa). Like the NRU, this rate is influenced by supply and demand conditions in the labour market and by the existing levels of trade union and business power; but it also takes into account a broader range of factors, among which are workers' education and skills, and their general 'employability'. Flexible labour markets will be associated with a lower NAIRU; in contrast, the NAIRU is not directly affected by aggregate demand or by the level of technological development.

Estimating the NAIRU empirically has proven difficult even for the rich countries. Calculations made with that purpose tend to vary significantly across countries, within countries (depending on the variables included in the study and the econometric methods used), and over time. These difficulties are even more severe in the case of poor countries, where employment data can be unreliable and the border between employment and unemployment (and between different categories of employment, such as part-time labour, underemployment and informal sector employment) can be very porous. This has rendered the NAIRU elusive and not very useful for policy analysis. In spite of this, it retains its prominence in the orthodox discourse.

**READINGS**

- Arestis, P. and Sawyer, M. (2006). 'Inflation Targeting: A Critical Appraisal', *Greek Economic Review*.
- Bruno, M. (1995). 'Does Inflation Really Lower Growth?' *Finance and Development* 32 (3), pp.35-38.
- Bruno, M. and Easterly, W. (1996). 'Inflation and Growth: In Search of a Stable Relationship', *Federal Reserve Bank of St. Louis Review* May-June, pp.139-146.
- Chang, H.-J. and Grabel, I. (2004). *Reclaiming Development: An Alternative Economic Policy Manual*. London: Zed Books.
- Chowdhury, A. (2004). *Thematic Summary Report: Monetary Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.
- Dornbusch, R. and Fischer, S. (1991). 'Moderate Inflation'. NBER Working Paper No. 3896.

Forder, J. (2003). 'Central Bank Independence: Economic Theory, Evidence and Political Legitimacy', *International Papers in Political Economy* 10 (2), pp.1-53.

Forder, J. (n.d.). 'The Theory of Credibility: Confusions, Limitations, and Dangers'. Manuscript.

McKinley, T. (2003). 'The Macroeconomics of Poverty Reduction: Initial Findings of the UNDP Asia-Pacific Regional Programme'. New York: UNDP.

McKinley, T. (2005b). 'Economic Alternatives for Sub-Saharan Africa: Poverty Traps, MDG-Based Strategies and Accelerated Capital Accumulation'. Paper presented at the G-24 Meeting, September.

Pollin, R. and Zhu, A. (2005). 'Inflation and Economic Growth: A Cross-Country Non-Linear Analysis', PERI Working Papers Series no.109, Department of Economics, University of Massachusetts Amherst.

### 3.4 DISTRIBUTIVE IMPLICATIONS OF INFLATION

Orthodox theory claims that inflation is especially costly for the poor, because their earnings (mainly wages, pensions and benefits) are fixed in nominal terms and thus tend to be easily eroded by inflation. The poor also hold a larger share of their assets in liquid form when compared to the rich, and these assets are devalued by inflation. Finally, the poor find it difficult to hedge against inflation because they lack access to the financial system.<sup>28</sup>

These losses are probably true, but this is not the full picture. First, if the real wage falls because of inflation, employment should rise, implying that there may be a short-run trade-off between inflation and unemployment. It is possible that the employment effect of inflation could outweigh the real wage effect on poverty, especially since estimates of the inflation (real wage) elasticity of poverty have found it to be significantly less than the output (employment) elasticity of poverty. For example, using pooled and cross-section data for 85 countries, Ghura *et al* have found that the inflation elasticity of the poor's income is 0.03, in contrast with an output (employment) elasticity of 0.94. These estimates are similar to others found in the literature.<sup>29</sup> Second, many poor people, especially in rural areas, are relatively less exposed to the monetary economy and less dependent on cash earnings than the urban population.<sup>30</sup> Third, the poor are often net debtors, with inflation possibly reducing their debt burden. Fourth, if the relative price of food increases through inflation, at least some of the poor might benefit if they are net food producers. Fifth, experiences in Latin America indicate that the *middle class* is especially vulnerable to high inflation, because it is highly dependent on monetary exchanges, has little surplus cash to invest and does not have much access to own produced basic goods.

Finally, numerous studies show that **the poor are heavily and disproportionately penalised by conventional (orthodox) disinflation programmes**.<sup>31</sup> The poor tend to lose in absolute as well as relative terms under these programmes. That is, they make the poor poorer and the rich relatively (if not absolutely) richer. They reduce real wages as well as the rate of economic growth, while increasing unemployment and the cost of debt, in addition to eliminating regulations that help to protect the living standards of the poor (see below). This tends to be the case regardless of whether the adjustment happens through output or prices – in either case, falling aggregate demand will have adverse implications for the poor.<sup>32</sup> If the adjustment happens through cuts in output and employment, the first group to lose its jobs is the unskilled and unorganised workers. If,



however, the adjustment happens through declines in wages, the level of welfare of the unorganised and unskilled workers is likely to deteriorate disproportionately. In either case, the average income of the poor is likely to drop as nominal GDP growth drops below trend. In fact, cross-country evidence shows that the average income of the poor is negatively related to aggregate demand variability. Consequently, in order to protect the poor, monetary policy needs to *stabilise output* in the face of adverse demand shocks.

Indonesian, Malaysian and Tanzanian data indicate that monetary tightening has a larger impact on small and medium enterprises (SMEs) than it does on larger firms, both in terms of persistence and variability of output.<sup>33</sup> That is, the output of the SME sector declines more sharply and the SMEs remain depressed for a longer period following a monetary contraction than is the case for larger industries. Since the SMEs are more dependent on bank lending for their working capital than large enterprises – which can rely on internal financing or raise funds from the capital market – a tighter monetary policy causes disproportionately more serious cash-flow problems for the SMEs. Such cash-flow problems are exacerbated as the SMEs' access to bank lending declines due to the drop in value of marketable collateral, concurrent with rising interest rates when the supply of bank loans is reduced.<sup>34</sup> Given the labour-intensive nature of SMEs, this is likely to have an adverse effect on the income of the poor and unskilled workers.

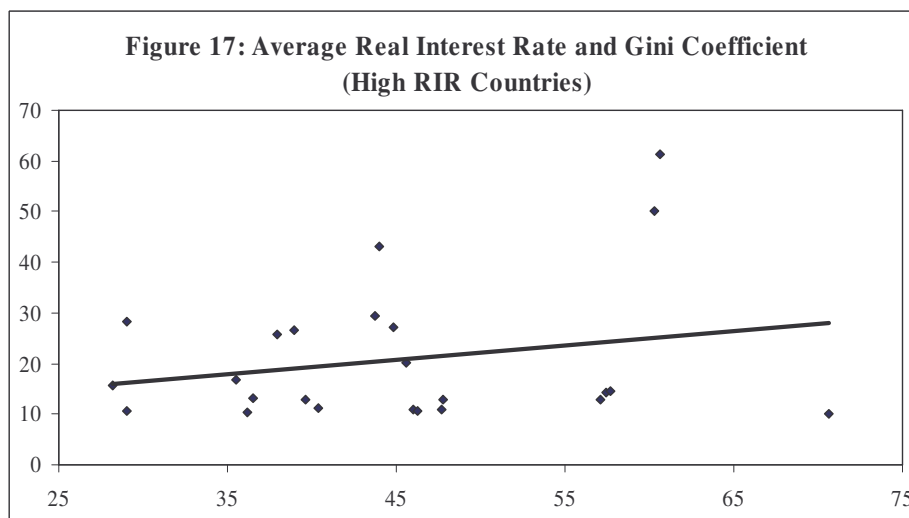
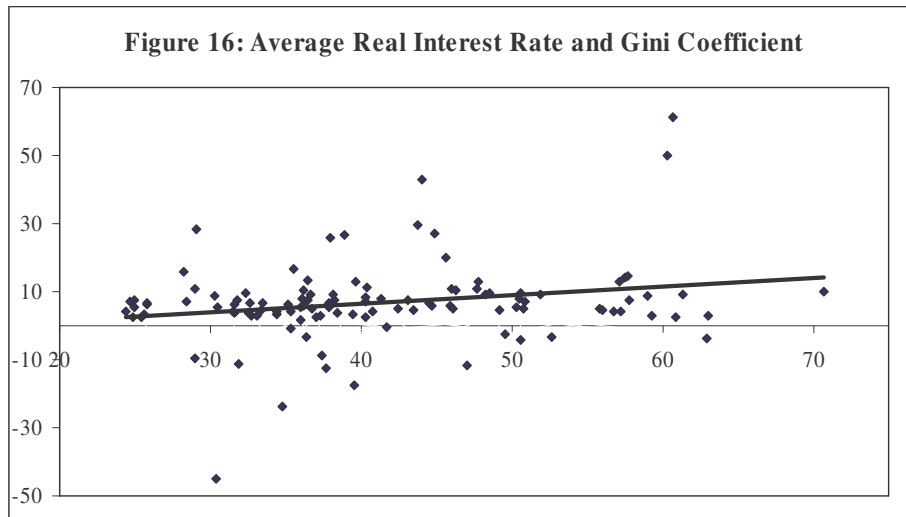
In sum, there seems to be no linear or stable relationship between inflation and the distribution of income, either in the short or long run. This relationship is indirect and highly complex, and simplistic claims that inflation is always or necessarily worse for the poor tend to draw on a small number of unrepresentative cases. In particular, ***moderate inflation seems to have no significant impact on poverty or distribution***, if one controls for the rate of economic growth.<sup>35</sup> It would be misguided to try to address ingrained problems of poverty and inequality through anti-inflation policies. Serious efforts to reduce poverty and improve the distribution of income require specific programmes involving several levels of government, rather than primarily or exclusively the monetary authorities. It is also curious that, even though the poor are supposed to lose heavily through inflation, it is the ***financial sector*** that tends to complain most loudly about the damage caused by inflation and to demand its elimination ***through orthodox stabilisation programmes***. This may indicate that – regardless of who loses out from inflation – ***orthodox stabilisation programmes systematically favour finance***:

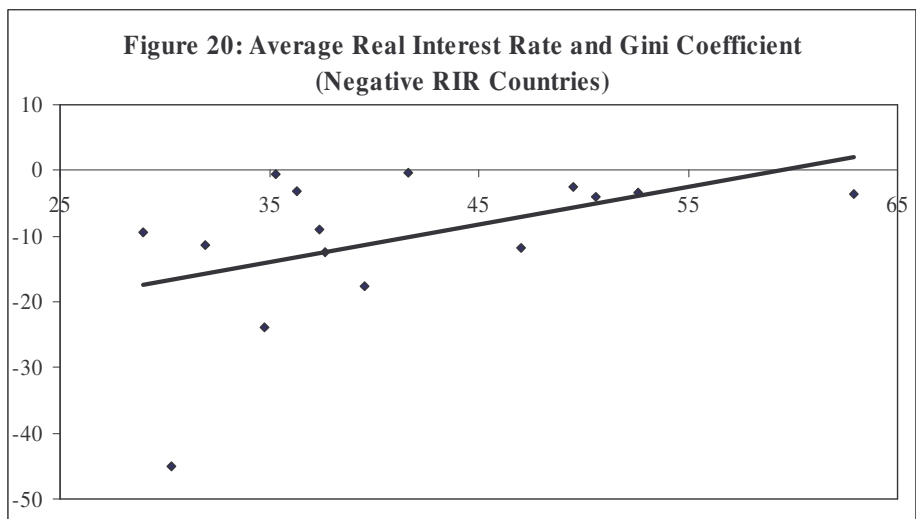
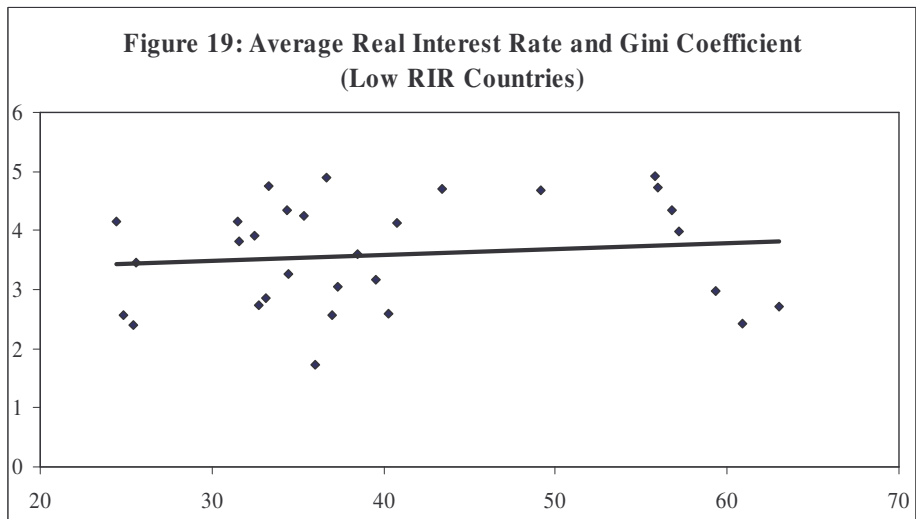
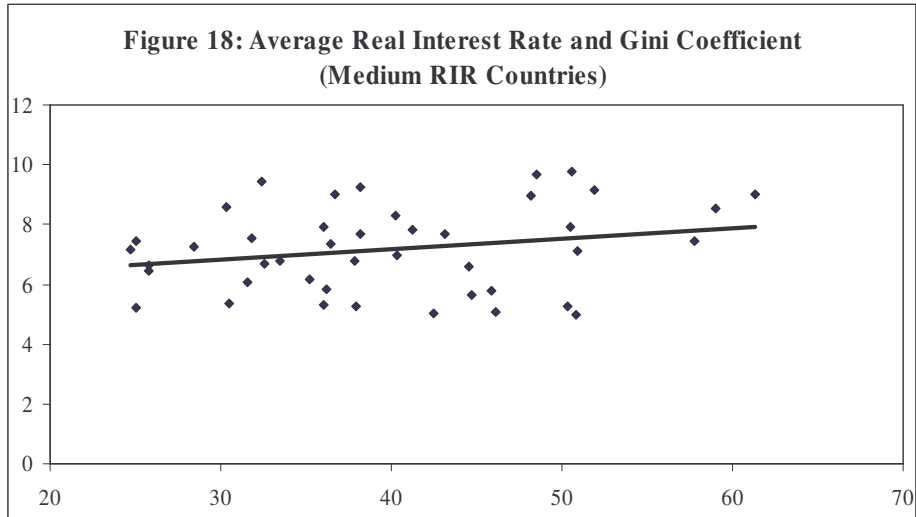
[T]he industrial community and export-oriented producers (and those employed in their enterprises) do not share with financiers an obsession with the prevention of inflation through restrictive monetary policy. Industrialists are often damaged by increases in borrowing costs that result from increases in interest rates. In addition, export-oriented producers are also often harmed by the appreciation of domestic currency that results from an increase in interest rates ... Thus the distributional effects of the monetary policy pursued by independent central banks are far from neutral.<sup>36</sup>

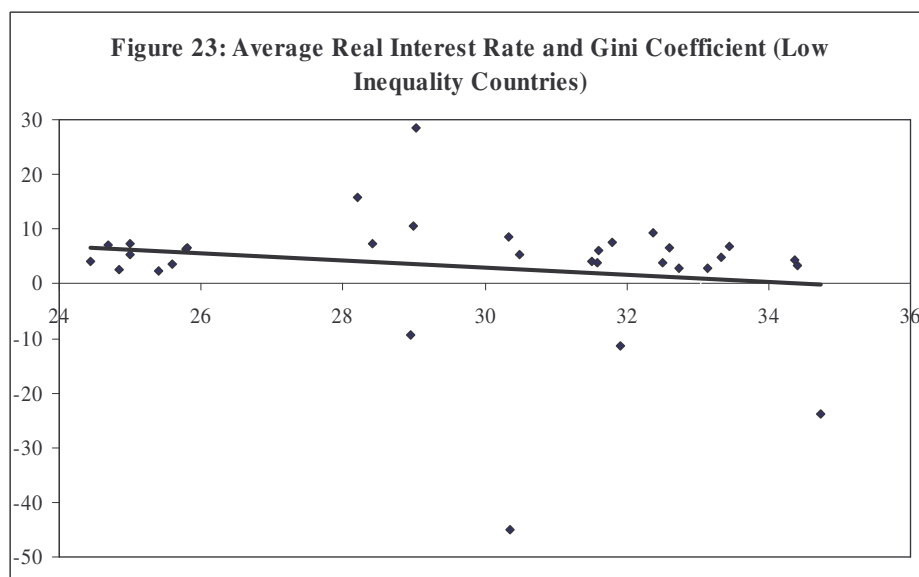
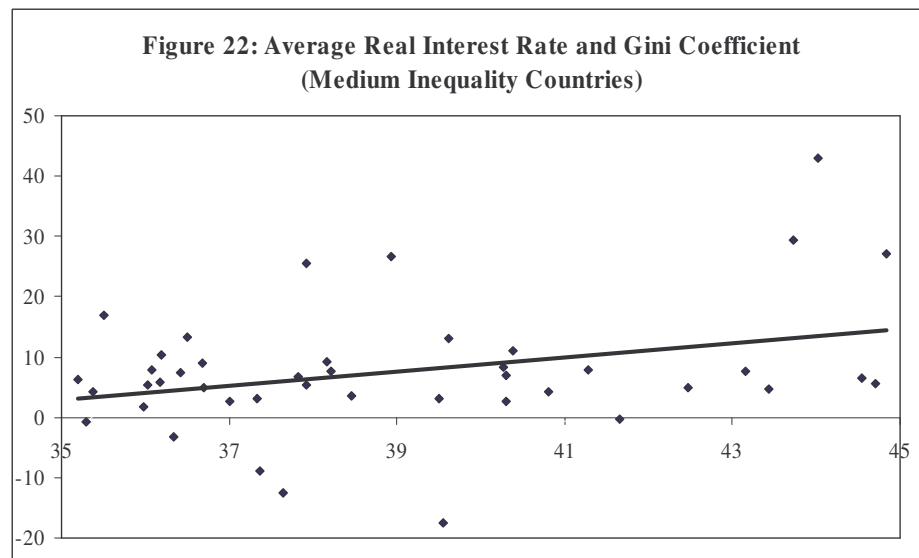
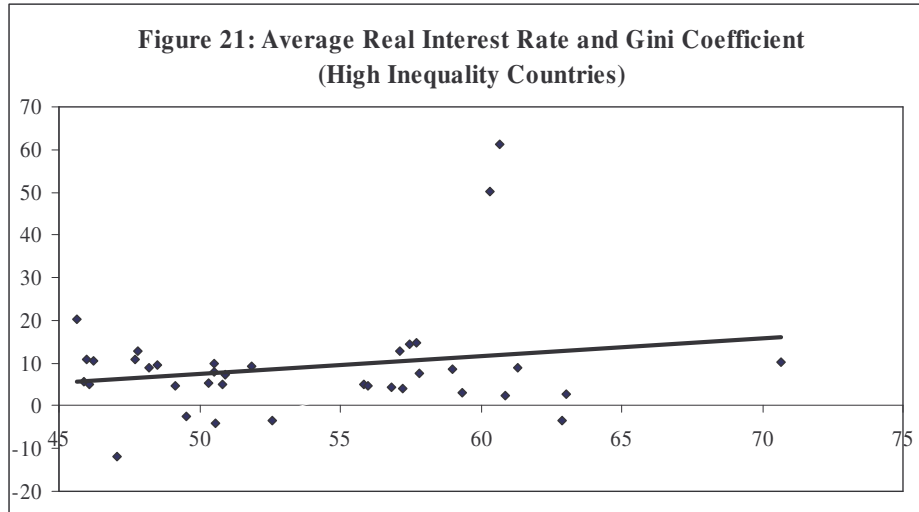
This claim finds support through a review of World Bank data on real interest rates (RIR) and Gini coefficients for 112 countries. A straightforward relationship between their average RIR (measured on the vertical axis) and their latest available Gini coefficient (measured on the horizontal axis) shows a clear positive correlation between these variables (see figure 16).

This relationship seems to be robust. If the sample is split between high RIR (above 10 per cent per annum; see below), medium RIR (5.0-9.9 per cent per annum), low RIR (0-4.9 per cent per annum) and negative RIR countries, a similar relationship holds (see figures 17-20). Conversely, the relationship also seems to hold (except in one case) if countries are divided between high

inequality (latest Gini above 45), medium inequality (Gini between 35 and 44.9) and low inequality countries (Gini below 34.9) (see figures 21-23). These relationships are only tentative and imprecise at this level of aggregation, but the evidence seems to be sufficiently suggestive to deserve further analysis.







**High RIR countries:** Armenia, Azerbaijan, Brazil, Cambodia, Cameroon, Chile, Colombia, Croatia, Ecuador, Gambia, Georgia, Israel, Kyrgyzstan, Macedonia, Madagascar, Moldova, Mongolia, Mozambique, Namibia, Nicaragua, Paraguay, Peru, Russia and Uruguay.

**Medium RIR countries:** Australia, Austria, Bangladesh, Belgium, Bolivia, Burkina Faso, Central African Republic, Costa Rica, Cote d'Ivoire, Denmark, El Salvador, Germany, Guinea, Honduras, India, Indonesia, Italy, Jamaica, Jordan, Kenya, Latvia, Malawi, Mali, Mexico, Netherlands, New Zealand, Niger, Norway, Panama, Papua New Guinea, Philippines, Poland, Rwanda, Senegal, Singapore, Slovakia, Slovenia, Sweden, Tanzania, Thailand, Trinidad and Tobago, Vietnam and Yemen.

**Low RIR countries:** Botswana, Burundi, Canada, China, Czech Republic, Egypt, Ethiopia, Finland, France, Greece, Guatemala, Hong Kong (POC), Hungary, Japan, Republic of Korea, Laos, Lesotho, Malaysia, Mauritania, Morocco, Nepal, Portugal, South Africa, Spain, Sri Lanka, Swaziland, Switzerland, United Kingdom, United States and Zimbabwe.

**Negative RIR countries:** Algeria, Belarus, Bulgaria, Estonia, Ghana, Guinea-Bissau, Lithuania, Nigeria, Sierra Leone, Tajikistan, Tunisia, Uganda, Ukraine, Venezuela and Zambia.

**High inequality countries:** Botswana, Brazil, Burkina Faso, Cameroon, Central African Republic, Chile, Colombia, Costa Rica, El Salvador, Ethiopia, Gambia, Guatemala, Guinea-Bissau, Honduras, Lesotho, Madagascar, Malawi, Malaysia, Mali, Mexico, Namibia, Nicaragua, Niger, Nigeria, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Russia, Rwanda, Sierra Leone, South Africa, Swaziland, Venezuela, Zambia and Zimbabwe.

**Medium inequality countries:** Algeria, Armenia, Australia, Azerbaijan, Bolivia, Cambodia, China, Cote d'Ivoire, Ecuador, Estonia, Georgia, Germany, Ghana, Greece, Guinea, Hong Kong (POC), India, Israel, Italy, Jamaica, Jordan, Kenya, Laos, Lithuania, Mauritania, Moldova, Mongolia, Morocco, Mozambique, Nepal, New Zealand, Portugal, Senegal, Singapore, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Uganda, United Kingdom, United States, Uruguay and Vietnam.

**Low inequality countries:** Austria, Bangladesh, Belarus, Belgium, Bulgaria, Burundi, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Hungary, Indonesia, Japan, Republic of Korea, Kyrgyzstan, Latvia, Macedonia, Netherlands, Norway, Poland, Slovakia, Slovenia, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Ukraine and Yemen.

## READINGS

Buliř, A. (2001). 'Income Inequality: Does Inflation Matter?' *IMF Staff Papers* 48 (1), pp.139-159.

Chang, H.-J. and Grabel, I. (2004). *Reclaiming Development: An Alternative Economic Policy Manual*. London: Zed Books.

Chowdhury, A. (2004). *Thematic Summary Report: Monetary Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.

Garuda, G. (2000). 'The Distributional Effects of IMF Programs: A Cross-Country Analysis', *World Development* 28, pp.1031-1051.

Pasha, H. A. and Palanivel, T. (2004). 'Pro-Poor Growth and Policies: The Asian Experience'. New York: UNDP.

Pastor, M. (1987). 'The Effects of IMF Programs in the Third World: Debate and Evidence from Latin America', *World Development* 15, pp.249-262.

Sahay, R., Cashin, P. and Mauro, P. (2001). 'Macroeconomic Policies and Poverty: The State of Play and a Research Agenda'. IMF website.

Vreeland, J.R. (2002). 'The Effect of IMF Programs on Labor', *World Development* 30 (1) pp.121-139.

## 4 INFLATION AND STABILISATION

This section reviews inflation and stabilisation policies from two angles: the role of inflation stabilisation in orthodox development strategies, and the role and implications of inflation targeting (IT), which has become one of the most popular frameworks for monetary policy in the world.

#### 4.1 ORTHODOX STRATEGIES

Comprehensive policy reforms have been imposed in most low- and middle-income countries during the last three decades through IMF and World Bank programmes of stabilisation and structural adjustment. In most countries, especially in sub-Saharan Africa and in Asia, these programmes were justified by balance of payments problems. In this sense, they bear some relationship with the original mandate of the IMF. Nevertheless, the related policy reforms were much broader and deeper than what could be justified by these countries' macroeconomic problems. The scope of policy reforms expanded gradually, to eventually encompass demands for profound changes in policies, institutional structures and governance, and to an almost complete abandonment of co-ordinated development policy by these low- and middle-income countries.

Virtually identical reforms were introduced in Latin America under the guise of ***inflation stabilisation programmes***. This is partly because the balance of payments constraint has been more severe in sub-Saharan Africa, South Asia, non-oil producing Middle Eastern and North African countries than in Latin America. In the latter, it has been possible to access foreign capital more readily than in other parts of the world, obviating the need for continuous IMF or donor support in order to achieve balance of payments equilibrium. This is also partly because inflation has been a persistent problem in this region since the 1950s, which makes Latin America a region of particular interest for the purposes of this module. Latin American inflation peaked at extremely high levels between the early 1970s and the early 1990s (see table 1), but it was later brought under control.

TABLE 1

##### Latin America: Annual Inflation Rates (GDP Deflator)

Country	Years > 50% <sup>a</sup>	Peak Rate, % <sup>b</sup>
Argentina <sup>c</sup>	1972-91	3,100 (1989)
Bolivia	1974, 1982-86	12,300 (1985)
Brazil	1979-95	2,500 (1990), 2,200 (1994)
Chile	1972-78	665 (1974)
Mexico	1982-88	140 (1987)
Nicaragua	1985-91	13,600 (1988)
Peru	1978-92	6,800 (1990)
Uruguay <sup>d</sup>	1972-92	192 (1973), 107 (1990)

Notes: a: Years in which inflation rates exceeded 50 per cent.

b: Peak annual inflation rate(s).

c: Except 1974.

d: Except 1974, 1976 and 1978-82.

Source: World Bank, *World Development Indicators 2003*. CD-Rom.

The inflation stabilisation policies implemented in Latin America between the late 1980s and the mid-1990s included contractionary fiscal and monetary policies, import liberalisation, liberalisation of the domestic financial system and the capital account of the balance of payments, and overvaluation of the exchange rate (either through an exchange rate peg or a currency board



system). The only significant difference between these policies and those associated with the Financial Programming model (explained in section 2.2) is the exchange rate level (devaluation helps to stabilise the balance of payments, while overvaluation can assist inflation control). The Latin American inflation stabilisation programmes and the traditional IMF programmes are otherwise identical, and both are similarly dependent on inflows of foreign capital for their continuing viability. In one case, these inflows are normally provided by the IMF; in the other, by private financial institutions.

In these experiences of inflation stabilisation, contractionary fiscal and monetary policies reduced demand and employment, which in turn diminished the workers' ability to resist reductions in their real wages. At the same time, drastic import liberalisation increased foreign competition and limited the prices that domestic firms could charge consumers (lest their markets would be lost to imports). Import liberalisation also indirectly helped to limit wage demands, as pay increases could make local firms uncompetitive. It was expected that the simultaneous liberalisation of the domestic financial system and the capital account of the balance of payments would help to increase savings and the availability of funds for investment. Unfortunately, the opposite tended to happen (see below). Finally, even severe inflationary episodes can be tamed by pegging the nominal exchange rate and letting the real exchange rise, making imports artificially cheap and reinforcing the inflation control mechanisms explained above. This combination of policies is not only effective against inflation; it can also be popular with consumers. However, it can have a severely negative impact on the balance of payments, local industry and employment.

The most obvious examples of the use of inflation stabilisation to shift macroeconomic policy towards orthodoxy took place in Argentina, Brazil and Mexico, through the 1991 convertibility plan, the 1994 *real* plan and the 1987 stabilisation programme, respectively. In all three cases, inflation stabilisation was accompanied by import growth, large current account deficits and the revaluation of the real exchange rate. Inflation stabilisation was also associated with substantial inflows of foreign capital, which financed the ensuing excess imports. Unfortunately, these capital inflows (approximately US\$1.0 trillion for Latin America as a whole between 1990 and 2001) were unstable. Ninety per cent of these funds left the region in a few years, and only US\$108 billion remained at the end of the 1990s. At the same time, savings and investment rates **declined** in all the region's countries (see table 2).

TABLE 2

**Argentina, Brazil and Mexico: Savings and Investment (% GDP)**

Argentina		Brazil		Mexico	
Savings	Investment	Savings	Investment	Savings	Investment
22 (1989)	29 (1975)	28 (1989)	25 (1989)	25 (1981)	26 (1981)
17 (1998)	18 (1999)	18 (1998)	20 (1998)	17 (1994)	19 (1994)

Source: World Bank, *World Development Indicators 2003*.

The net inflows of foreign capital were insufficient to compensate for the decline in domestic savings and investment, which led to the deterioration of national economic performance across the region (see table 3). Table 3 indicates that economic growth rates deteriorated significantly in Argentina, Brazil and Mexico, after the collapse of import-substituting industrialisation (from 3.8, 6.3 and 6.4 per cent per annum, respectively, over a period of nearly 50 years, to only 1.6 per cent,

2.1 per cent and 2.7 per cent in the following 20 years). Even if one excludes the 1980s – for example, in order to eliminate the one-off costs associated with the international debt crisis and the transition to neoliberalism that marked that period – the average economic performance of these countries fails to improve significantly, except in the case of Argentina. However, it is widely known that this latter country was engulfed by a severe economic crisis in the early years of the current century. Thus, it is hardly an example to be followed by other countries.

TABLE 3

**Average Annual GDP Growth Rates (%)**

Argentina	Brazil	Mexico
3.8 (1933-1974)	6.3 (1933-1980)	6.4 (1933-1981)
1.6 (1981-2000)	2.1 (1981-2000)	2.7 (1981-2000)
4.5 (1990-2000)	2.7 (1990-2000)	3.9 (1990-2000)

Source: Oxford Latin American economic history database, <<http://oxlad.qeh.ox.ac.uk/>>.

The experience of high inflation in sub-Saharan Africa (the other poor region where high inflation was a chronic problem) was substantially different, not only in terms of the trigger for policy changes (balance of payments problems rather than inflation), but also in terms of the sources of additional foreign currency resources (ODA rather than market processes). The African economies are also structured differently; their population densities, social structures, soil, infrastructure provision, urbanisation, the size of their market for durable goods, degree of oligopoly in key markets, and other aspects of economic activity, are all distinct from what is found in Latin America. Moreover, the complexity of these economies also tends to vary in degree. Several high-inflation African countries were also plagued by war, which was not the case in Latin America (with the exception of Nicaragua). In this sense, the policy shifts in Africa responded to different determinants. **But their content and eventual outcomes were the same:** inflation declined and the balance of payments edged towards sustainability, with hiccups and continuing dependence on capital inflows over time. However, in most cases the economy failed to react. Unemployment and underemployment mounted, inequality rose and social tensions climbed. Policy alternatives have been increasingly demanded, as the majority of the population becomes exasperated with the failure of the orthodox 'reforms' to achieve their stated outcomes.

## READING

Saad-Filho, A. (2005b). 'The Political Economy of Neoliberalism in Latin America', in A. Saad-Filho and D. Johnston (eds.), *Neoliberalism: A Critical Reader*. London: Pluto Press, 2005.

## 4.2 INFLATION TARGETING

Since the early 1990s, inflation targeting (IT) has become the dominant ('best-practice') monetary policy paradigm in several rich and middle-income countries.<sup>37</sup> In addition to those countries currently following full-fledged IT policies, several dozen countries have adopted IT either

informally or implicitly—for example, pursuing ‘inflation caps’ (maximum desired inflation rates) in the context of their IMF programmes. These ‘caps’ are insufficient to define these policy regimes as IT, although they are symptomatic of a medium-term goal of moving towards IT. In spite of its currently fashionable or iconic status, IT is generally an undesirable framework for monetary policy from the point of view of a pro-poor development strategy.

IT is a legally-binding target rate of inflation that must be pursued by the central bank. The target can be a point or an interval including tolerance margins. The IT should be the *only* nominal anchor in the economy, as inflation targets cannot be pursued simultaneously with money supply, wages, employment or exchange rate targets (consequently, IT requires a managed floating exchange rate regime). Advocates of this policy regime claim that the IT regime (ITR) operates at multiple levels. At the level of government, it institutionalises ‘good’ (i.e., orthodox) monetary policies, increases the transparency and accountability of the central bank and provides guidelines for other government policies. IT also helps to shape private sector expectations, thereby reducing uncertainty and the costs associated with the necessary adjustment to the new, low inflation regime. These potential benefits suggest that other government policy objectives – such as employment generation, economic growth and income distribution – should be subordinated to IT.

Policy prescriptions for IT draw on the revision of inflation theory and on the practice of monetary policy adopted since the 1980s, which was based on the convergence between monetarist, new classical and new Keynesian approaches. IT also builds upon the orthodox view that government intervention in the economy is either useless or counterproductive, and that inflation is largely due to fiscal deficits, adverse expectations and lack of policy credibility. This interpretation of inflation has two policy implications. First, inflation control demands ‘credible’ macroeconomic policies, which, in essence, require the adoption of the orthodox policy menu. It also requires monetary policy rules rather than discretion, in addition to the liberalisation of the capital account of the balance of payments and the elimination of residual inflationary pressures through import liberalisation and direct and indirect wage restrictions (see section 2). Second, these policies have been institutionally supplemented by central bank independence (CBI), which is supposed to ‘discipline the politicians’ and remove the inflation bias that is said to exist when they control economic policy.

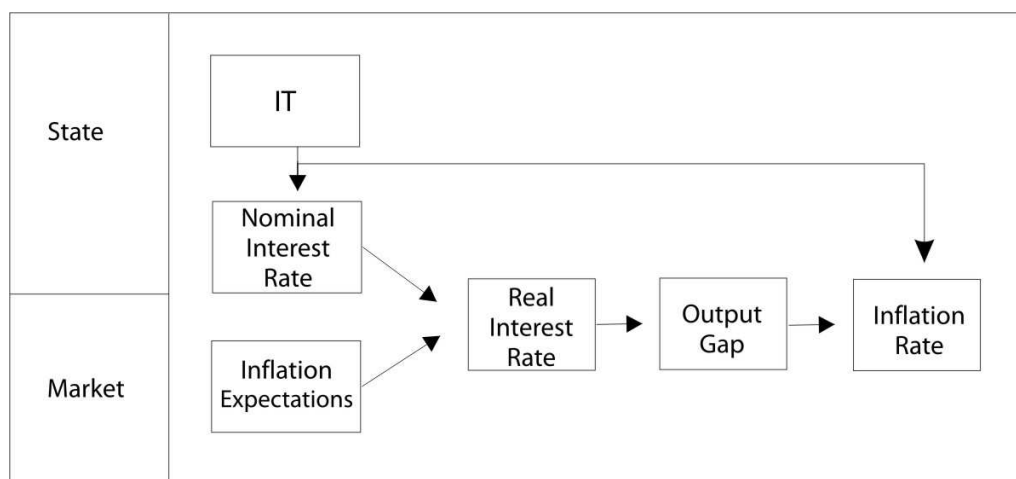
In contrast with exchange-rate targeting, IT is not a stabilisation strategy: it can be introduced only when inflation is already low, and it operates optimally when the financial markets have already been liberalised. In spite of this limitation, IT is widely considered to be the policy regime most favourable to the consolidation of low inflation, because it leaves very little institutional space for the deviation of monetary policy from the goal of preserving the value of money. Therefore, this is a stable and potentially durable monetary policy regime.

The economic model underpinning the ITR is very simple (see figure 24). It includes two key parameters: the IT and expectations of inflation. The former is set by the government, while the latter arises from the private sector. The model also includes one discretionary policy instrument: the nominal interest rate.

The main objective of the central bank is to eliminate the inflation gap, or the difference between the rate of inflation and the IT, at some point in the future (the ‘policy horizon’, usually set at between one and three years).<sup>38</sup> The model presumes that inflation is jointly determined by the inflation expectations of the private (mainly financial) sector and by the output gap, with the latter fluctuating around a supply-side equilibrium. In other words, given the state of expectations, a negative output gap (output above full capacity) implies rising inflation, while a positive output gap should help to reduce inflation. Reciprocally, given the level of capacity utilisation (and the output gap), high inflation expectations will tend to be self-fulfilling, and vice-versa. Another way to put this interpretation of inflation is the following. The rate of unemployment presumably

fluctuates around the NAIRU, with unemployment below (above) the NAIRU leading to higher (lower) inflation. The output gap (expressed as the difference between the current rate of unemployment and the NAIRU) is determined by the level of the real interest rates (high real interest rates raise the output gap, while low interest rates stimulate economic activity and reduce this gap). Finally, the real interest rate is, by definition, equal to the nominal interest rate minus inflation expectations.

FIGURE 24

**Inflation Targeting**

In this model, the central bank attempts to hit the IT by manipulating the nominal interest rate in order to influence expectations and, at a further remove, fine tune the level of aggregate demand. If the central bank forecasts a positive inflation gap, either because aggregate demand is too high or because the market expects inflation to rise in the future (for whatever reason), it will raise nominal (and, *ceteris paribus*, real) interest rates. Conversely, if the inflation gap is negative or if the expected rate of inflation is too low, the central bank will reduce nominal interest rates. The output gap will fall, and inflation will rise, converging to the target.

ITR has questionable macroeconomic implications (see Box 4). In addition to this, it may entail four economic costs, which should be taken into account in the assessment of this policy regime.

1. **The cost of targeting very low inflation:** ITR is invariably based on pursuing very low inflation targets, usually below five per cent. The pursuit of excessively low inflation can be costly because it fosters output volatility and can lock the economy into a low-level equilibrium with low growth, high unemployment and intractable problems of poverty and inequality. If IT requires permanently contractionary policies, it can also have negative distributive implications, making this policy regime potentially incompatible with the achievement of MDGs and other pro-poor goals.
2. **The cost of high real interest rates:** Since inflation control in ITR is achieved primarily through the manipulation of interest rates, they tend to be higher under this policy regime than under an alternative regime in which other instruments play a more significant role in inflation control. It was shown above that high interest rates can reduce inflation, but they can also be destabilising and lead to economic stagnation and concentration of income.

- 3. The cost of conflicts between IT and balance of payments equilibrium:** IT is especially costly for relatively open economies, because some of their policy instruments must be committed to maintaining a sustainable balance of payments position, dealing with external shocks and contending with the additional channels linking policy variables and outcomes (for example, the employment effect of exchange rate changes). IT may conflict with balance of payments equilibrium at two levels. First, there may be conflicting demands on interest rates (as shown above). Second, it may be especially difficult to pursue IT if the private sector has large foreign currency liabilities. These currency mismatches will create demands for the central bank to maintain exchange rate stability, although this is ultimately incompatible with the IT regime. It is possible that, under these circumstances, IT may be wholly inappropriate, and a hard exchange rate peg may be more desirable, especially for very small open economies with concentrated trade patterns.
- 4. The cost of conflicts between IT and financial stability:** Although the central bank is the main state institution responsible for achieving IT, it is also the bank of banks and the institution responsible for preserving the stability of the domestic financial system. Under normal circumstances, these two mandates are compatible. However, they may come into conflict if the asset and product markets give contradictory signals about inflation, if asset prices are very volatile, or if asset prices rise rapidly as a proportion of GDP. For example, if price inflation escalates, the central bank may have to raise interest rates, which could undermine financial system stability and trigger a costly crisis. Alternatively, if deflation looms, the central bank may have to lower interest rates, although this may fuel a destabilising bout of asset price inflation.

These difficulties and costs are symptomatic of three profound problems of IT, as seen from the point of view of pro-poor economic strategies. First, ITR is theoretically inconsistent, because there is no guarantee that a single interest rate can simultaneously deliver low inflation (through demand control), low unemployment, exchange rate stability, balance of payments equilibrium and a sustainable fiscal position. Second, ITR turns very low inflation – a *means* to growth and welfare improvement – into the most important macroeconomic policy *objective*. In contrast, pro-poor policies focus directly on the achievement of socially desirable outcomes. Third, IT compels monetary policy to throttle demand whenever inflation rises above an arbitrary – and invariably very low – target level. This strategy can maintain very low inflation, but at a high economic cost and at the expense of long-term equitable growth and achievement of the MDG targets. More generally, the excessive focus of ITR on inflation control can distract attention from financial markets and international capital flows as potential sources of instability. This is misguided, because the cost of financial and balance of payments crises can easily exceed the cost of moderate inflation.

Anti-inflation strategies based on IT are especially inappropriate for very poor countries. These countries invariably have great difficulty in fulfilling the institutional requirements for IT, and they tend to have unstable balance of payments and shallow and fragile financial systems, which restricts the scope for, and the efficiency of, interest rate manipulation to achieve macroeconomic outcomes. Moreover, in these countries the single-minded pursuit of very low inflation can lock the economy into a low-employment equilibrium, in which the government may be unable to tackle the pressing problems of poverty. These difficulties are inherently related to poverty, and they cannot be wished away or addressed purely through attempts to accumulate ‘credibility’, as claimed by the orthodoxy.

## BOX 4

**Performance of Inflation Targeting Regimes**

There is a vast literature assessing the performance of ITR. Several studies have identified gains in such areas as lower inflation rates, volatility and inertia, improved expectations, faster absorption of adverse shocks, lower sacrifice ratio (the output cost of reducing inflation), output stabilisation, and the convergence of poorly performing countries toward well-performing country standards (see, for example, Bernanke et al. 1999, Debelle et al. 1998, Mishkin 1999 and Mishkin and Schmidt-Hebbel 2002). However, other studies have been less supportive of IT (for example, Agénor 2001, Cecchetti and Ehrmann 1999, Chang and Grabel 2004, pp.183-4, and Neumann and von Hagen 2002). They claim that there is no convincing evidence that IT improves economic performance as measured by the behaviour of inflation, output or interest rates, and it may even lead to a deterioration of some indicators, especially unemployment. These conflicting conclusions are partly due to the different approaches and econometric methodologies used in these studies. However, there may be another reason for such discrepant assessments of IT.

There are strong indications that the performance of most OECD countries has improved, in terms of inflation, output volatility and interest rates, during the last 10-15 years. These improvements are evident both in IT and non-IT countries, which suggests that they are due to something *other* than IT. Even where the performance of IT countries has improved more than that of non-IT countries, it cannot be simply assumed that the difference is due to IT. Ball and Sheridan (2003) find strong evidence that the countries showing the greatest performance improvements in the 1990s were those with the worst performance in the previous period. In other words, such countries tended to have worse initial performance and, perhaps for this reason, they were more easily tempted to adopt IT. These countries eventually found that their performance improved – but not because of IT. More prosaically, for Ball and Sheridan they simply '**regressed towards the mean**'. In this sense, the apparent success of IT countries is due merely to their having 'high initial inflation and large decreases, but the decrease for a given initial level looks similar for targeters and non-targeters' (p.16). Once they control for regression towards the mean, Ball and Sheridan find that there is no evidence that IT improves economic performance in aspects that include inflation, interest rates, inflation variance, output and interest rates, or the persistence of shocks:

There is no evidence whatsoever that inflation targeting reduces inflation variability ... Our robust finding is that inflation targeting has no beneficial effects ... [T]here is no evidence that targeting affects inflation behavior (pp.11-12).

Ball and Sheridan also claim that it is illegitimate to draw *any* conclusions about growth performance because the available time samples are simply too short, and because the economies being studied started at different points in the economic cycle. Consequently, all that can be concluded is that:

a paper that replicates this study in 25 or 50 years may find ample evidence that targeting improves performance. The evidence is not there, however, in the data through 2001 (p.17).

In sum, in the words of Arestis and Sawyer (2006):

"Both IT and non-IT countries performed over the IT period equally well. The average rate of inflation and its variance have been reduced in both periods. This is true for both IT and non-IT countries ... We may conclude... by suggesting that on the basis of the average inflation and GDP growth rates performance, there is not much difference between IT and non-IT countries ... Consequently, IT has been a great deal of fuss about really very little!"



## READINGS

- Agénor, P. R. (2001). 'Monetary Policy under Flexible Exchange Rates: An Introduction to Inflation Targeting'. IMF website.
- Bernanke, B. S., Laubach, T., Mishkin, F. and Posen, A. S. (1999). *Inflation Targeting: Lessons from the International Experience*. Princeton: Princeton University Press.
- Carare, A. and Stone, M. R. (2003). 'Inflation Targeting Regimes'. IMF Working Paper No. 03/9.
- Cecchetti, S. G. and Ehrmann, M. (1999). 'Does Inflation Targeting Increase Output Volatility? An International Comparison of Policymakers' Preferences and Outcomes'. NBER Working Paper No. 7426.
- Chang, H.-J. and Grabel, I. (2004). *Reclaiming Development: An Alternative Economic Policy Manual*. London: Zed Books.
- Debelle, G., et.al. (1998). 'Inflation Targeting as a Framework for Monetary Policy', *Economic Issues*, No. 15, IMF, Washington, DC.
- Mishkin, F. S. (1999). 'Inflation Experiences with Different Monetary Policy Regimes', *Journal of Monetary Economics* 43, pp.579-605.
- Mishkin, F. S. and Schmidt-Hebbel, K. (2002). 'A Decade of Inflation Targeting in the World: What Do We Know and What Do We Need to Know?', in N. Loayza and R. Soto (eds.), *Inflation Targeting: Design, Performance, Challenges*. Santiago: Central Bank of Chile.
- Neumann, M. J. M. and von Hagen, J. (2002). 'Does Inflation Targeting Matter?', *Federal Reserve Bank of St Louis Review* 84, pp.149-153.
- Stone, M. R. and Bhundia, A. J. (2004). 'A New Taxonomy of Monetary Regimes'. IMF Working Paper No. 04/191.

## 5 CONCLUSION

Monetary policy is not merely a technical tool. In most countries, it plays an instrumental role in the reproduction of poverty and inequality, especially in the context of unduly contractionary orthodox stabilisation and structural adjustment programmes. Monetary policy can play an even more consistently regressive role through inflation-targeting policies and programmes, which can be virtually set in stone by legislation securing central bank independence. However, monetary policy can also give an important contribution to pro-poor growth strategies and programmes, especially through its contribution to more growth-accommodating government policies, its influence on the allocation of resources, and the facilitation of regulations on international capital flows.

This Training Module has reviewed the nature and content of monetary policy, including its macroeconomic role and the policy tools that may be used in order to implement alternative monetary policy stances. The Module has also outlined the evolution of monetary policy in recent decades, and the reasons underpinning the shift seen from Keynesian (activist, and generally expansionary) policies in the so-called 'golden age' to orthodox (persistently contractionary) policies typical of the current age of neoliberalism. In addition to this, the Module has discussed in detail the theoretical structure and policy rationale underpinning the orthodox policies promoted by the international financial institutions (especially the IMF and the World Bank), in the form of stabilisation and structural adjustment programmes.



Finally, the Module has examined the implications of inflation, especially in terms of its macroeconomic and distributive costs. Different views of these costs, especially concerning the magnitude and incidence of their impact on specific social groups, have helped to inform distinct approaches to inflation stabilisation. It was shown, in this context, that views on the consequences of inflation have changed over time, as different interpretations of this process have become dominant in different periods. In spite of this, the orthodoxy has remained wedded to the claims that inflation is highly costly and that these costs fall most heavily upon the poor. These claims have been found wanting, first, because the adverse distributive implications of inflation are often exaggerated in orthodox analysis. The second reason is that the calculation of inflation costs cannot be separated from the potential economic benefits of moderate inflation associated with higher levels of employment and economic activity--especially if the alternative to moderate inflation is the imposition of very low inflation through permanently contractionary orthodox policies.

Recent specialised literature suggests that moderate inflation (approximately within the 10-40 per cent range) may not have negative implications for macroeconomic performance, and it may not transfer a significant share of income to the rich. It is especially intriguing that, depending on the institutional arrangements in the economy, the financial sector may be *more* adversely affected by inflation than the poor. While the poor may be net food producers and only marginally integrated into monetary circuits, the economic reproduction of the financial sector is inextricably linked to monetary transactions, in which the value of money plays an essential role. Moreover, if inflation stabilisation is achieved through orthodox policies, the financial sector tends to gain as these policies transfer the state's capacity to allocate resources intertemporally and intersectorally to the banks, the non-bank financial firms and the stock market.

Similar considerations of costs and benefits hold for pro-poor monetary policy. Pro-poor monetary policies recognise the costs of inflation for the poor in terms of their income levels and of the distribution of income, as well as the costs for the poor of the orthodox inflation stabilisation strategies. They also take into account empirical evidence showing that stable moderate inflation may have little adverse macroeconomic or distributional consequences, and that the orthodox obsession with very low inflation can be bad for the poor because it is associated with slow growth, high unemployment and high interest rates for long periods.

In sum, this Training Module has shown that the choice between the orthodox and pro-poor approaches to monetary policy involves not only their internal consistency, but also the political constraints influencing the selection of economic policy in each country. More specifically, the *most important* constraint to the introduction of pro-poor monetary policy strategies in many poor countries is not scarcity of resources or lack of government institutional capacity. Rather, it is the lack of political will to confront the ruling (orthodox) policy consensus and build alternatives based on the joint efforts of governments, progressive economists and civil society.

## REFERENCES

- Agénor, P. R. (2001). 'Monetary Policy under Flexible Exchange Rates: An Introduction to Inflation Targeting'. IMF website.
- Agosin, M. R. and Tussie, D. (eds.) (1993). *Trade and Growth: New Dilemmas in Trade Policy*. London: Macmillan.
- Arestis, P. and Sawyer, M. (2006). 'Inflation Targeting: A Critical Appraisal', *Greek Economic Review*.
- Argitis, G. and Pitelis, C. (2001). 'Monetary Policy and the Distribution of Income: Evidence for the United States and the United Kingdom', *Journal of Post Keynesian Economics* 23 (4), pp.617-638.
- Aybar, S. and Lapavitsas, C. (2001). 'Financial System Design and the Post-Washington Consensus', in B. Fine, C. Lapavitsas and J. Pincus (eds.), *Development Policy in the Twenty-first Century: Beyond the Post-Washington Consensus*. London: Routledge.
- Ball, L. and Sheridan, N. (2003). 'Does Inflation Targeting Matter?' IMF Working Paper No. 03/129.
- Bernanke, B. S. and Mishkin, F. (1997). 'Inflation Targeting: A New Framework for Monetary Policy?', *Journal of Economic Perspectives* 11 (2), pp.97-116).
- Bernanke, B. S., Laubach, T., Mishkin, F. and Posen, A. S. (1999). *Inflation Targeting: Lessons from the International Experience*. Princeton: Princeton University Press.
- Bruno, M. (1995). 'Does Inflation Really Lower Growth?' *Finance and Development* 32 (3), pp.35-38.
- Bruno, M. and Easterly, W. (1996). 'Inflation and Growth: In Search of a Stable Relationship', *Federal Reserve Bank of St Louis Review* May-June, pp.139-146.
- Buira, A. (2003). 'An Analysis of IMF Conditionality', G-24 Discussion Paper no.22, G-24 website.
- Buliř, A. (2001). 'Income Inequality: Does Inflation Matter?' *IMF Staff Papers* 48 (1), pp.139-159.
- Campbell, A. (2005). 'The Birth of Neoliberalism in the United States: A Reorganisation of Capitalism', in A. Saad-Filho and D. Johnston (eds.), *Neoliberalism: A Critical Reader*. London: Pluto Press.
- Carare, A. and Stone, M. R. (2003). 'Inflation Targeting Regimes'. IMF Working Paper No. 03/9.
- Carlin, W. and Soskice, D. (1990). *Macroeconomics and the Wage Bargain: A Modern Approach to Employment, Inflation and the Exchange Rate*. Oxford: Oxford University Press.
- Cecchetti, S. G. and Ehrmann, M. (1999). 'Does Inflation Targeting Increase Output Volatility? An International Comparison of Policymakers' Preferences and Outcomes'. NBER Working Paper No. 7426.
- Chandrasekhar, C. P. (2004). *Thematic Summary Report: Financial Liberalisation*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.
- Chang, H.-J. (1994). *The Political Economy of Industrial Policy*. London: Macmillan.
- Chang, H.-J. (2003). *Globalisation, Economic Development and the Role of the State*. London: Zed Books.
- Chang, H.-J. and Grabel, I. (2004). *Reclaiming Development: An Alternative Economic Policy Manual*. London: Zed Books.

- Chowdhury, A. (2004). *Thematic Summary Report: Monetary Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.
- Clarke, S. (1988). *Keynesianism, Monetarism, and the Crisis of the State*. Aldershot: Edward Elgar.
- Debelle, G., et.al. (1998). 'Inflation Targeting as a Framework for Monetary Policy', *Economic Issues*, No. 15, IMF, Washington, DC.
- Demigürç-Kunt, A. and Levine, R. (1999). 'Bank-Based and Market-Based Financial Systems: Cross-Country Comparisons', manuscript, internet.
- Díaz-Alejandro, C. (1985). 'Good-Bye Financial Repression, Hello Financial Crash', *Journal of Development Economics*, 19, pp.1-24.
- Dornbusch, R. and Fischer, S. (1991.) , 'Moderate Inflation'. NBER Working Paper No. 3896.
- Epstein, G., Grabel, I. and Jomo K. S. (2003). 'Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future'. G-24 Discussion Paper, G-24 website.
- Fine, B. (2005). 'The Developmental State and the Political Economy of Development', in Jomo K. S. and B. Fine (eds.), *The New Development Economics after the Washington Consensus*. London: Zed Books and New Delhi: Tulika Books.
- Fine, B., Lapavistas, C. and Pincus, J. (eds) (2001). *Development Policy in the Twenty-first Century: Beyond the Post-Washington Consensus*, London: Routledge.
- Fischer, S., Sahay, R. and Végh, C. (2002). 'Modern Hyper- and High Inflation', *Journal of Economic Literature* 40, pp.837-880.
- Forder, J. (2003). 'Central Bank Independence: Economic Theory, Evidence and Political Legitimacy', *International Papers in Political Economy* 10 (2), pp.1-53.
- Forder, J. (n.d.). 'The Theory of Credibility: Confusions, Limitations, and Dangers'. Manuscript.
- Friedman, M. (1968). 'The Role of Monetary Policy', *American Economic Review*, Vol. 78, B1-17.
- Friedman, M. (1973). *Money and Economic Development*, Toronto: Lexington Books
- Garuda, G. (2000). 'The Distributional Effects of IMF Programs: A Cross-Country Analysis', *World Development* 28, pp.1031-1051.
- Gereffi, G. and Wyman, D. L. (eds.) (1990). *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia*. Princeton: Princeton University Press.
- Kaplan, E. and Rodrik, D. (2000). 'Did the Malaysian Capital Controls Work?' Internet.
- Keynes, J. M. (1973). *The General Theory of Employment, Interest and Money*. Collected Works VII. London: Macmillan.
- Levacic, R. and Rebmann, A. (1982). *Macroeconomics: An Introduction to Keynesian-Neoclassical Controversies*. London: Macmillan.
- Levine, R. (1997). 'Financial Development and Economic Growth: Views and Agenda', *Journal of Economic Literature* 35, pp.688-726.
- MacEwan, A. (2003). 'Debt and Democracy: Can Heavily Indebted Countries Pursue Democratic Economic Programs?' Paper presented at the symposium 'Common Defense Against Neoliberalism', Istanbul.

- Marglin, S. and Schor, J. (1990). *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*. Oxford: Clarendon Press.
- McKinley, T. (2005b). 'Economic Alternatives for Sub-Saharan Africa: Poverty Traps, MDG-Based Strategies and Accelerated Capital Accumulation'. Paper prepared for the G-24 Meeting, September.
- McKinley, T. (2005a). 'MDG-Based PRSPs Need More Ambitious Economic Policies'. UNDP Discussion Paper, January.
- McKinley, T. (2003). 'The Macroeconomics of Poverty Reduction: Initial Findings of the UNDP Asia-Pacific Regional Programme'. New York: UNDP.
- McKinley, T. (ed.) (2001). 'Introduction', in *Macroeconomic Policy, Growth and Poverty Reduction*. London: Palgrave.
- Milanovic, B. (2003). 'The Two Faces of Globalization: Against Globalization as We Know It', *World Development* 31 (4), pp. 667–683.
- Mishkin, F. S. (1999). 'Inflation Experiences with Different Monetary Policy Regimes', *Journal of Monetary Economics* 43, pp.579-605.
- Mishkin, F. S. and Schmidt-Hebbel, K. (2002). 'A Decade of Inflation Targeting in the World: What Do We Know and What Do We Need to Know?', in N. Loayza and R. Soto (eds.), *Inflation Targeting: Design, Performance, Challenges*. Santiago: Central Bank of Chile.
- Neumann, M. J. M. and von Hagen, J. (2002). 'Does Inflation Targeting Matter?', *Federal Reserve Bank of St. Louis Review* 84, pp.149-153.
- Pasha, H. A. and Palanivel, T. (2004). 'Pro-Poor Growth and Policies: The Asian Experience'. New York: UNDP.
- Pastor, M. (1987). 'The Effects of IMF Programs in the Third World: Debate and Evidence from Latin America', *World Development* 15, pp.249-262.
- Pollin, R. and Zhu, A. (2005). 'Inflation and Economic Growth: A Cross-Country Non-Linear Analysis', PERI Working Papers Series no.109, Department of Economics, University of Massachusetts Amherst.
- Roy, R. and Weeks, J. (2003). *Thematic Summary Report: Fiscal Policy*. UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.
- Saad-Filho, A. (2005a). *Pro-Poor Monetary and Anti-Inflation Policies: Developing Alternatives to the New Monetary Policy Consensus*. Manuscript.
- Saad-Filho, A. (2005b). 'The Political Economy of Neoliberalism in Latin America', in A. Saad-Filho and D. Johnston (eds.), *Neoliberalism: A Critical Reader*. London: Pluto Press, 2005.
- Sahay, R., Cashin, P. and Mauro, P. (2001). 'Macroeconomic Policies and Poverty: The State of Play and a Research Agenda'. IMF website.
- Screpanti, E. and Zamagni, S. (1993). *An Outline of the History of Economic Thought*. Oxford: Oxford University Press.
- Stiglitz, J. (2002). 'Macro-Policy Issue: Dealing with an Economic Downturn', The Task Force on Macroeconomic Policy, Initiative for Policy Dialogue, Columbia University.
- Stone, M. R. and Bhundia, A. J. (2004). 'A New Taxonomy of Monetary Regimes'. IMF Working Paper No. 04/191.

Tarp, F. (1993). *Stabilisation and Structural Adjustment: Macroeconomic Frameworks for Analysing the Crisis in Sub-Saharan Africa*. London: Routledge.

Unctad (2002). *The Least Developed Countries Report*, Chapter 5: 'National Development Strategies, the PRSP Process and Effective Poverty Reduction'. New York: Unctad.

Vreeland, J. R. (2002). 'The Effect of IMF Programs on Labor', *World Development* 30 (1) pp.121-139.

Zysman, J. (1983). *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change*. Oxford: Martin Robertson.

.

## NOTES

1. The author is grateful to Terry McKinley, Acting Director of the International Poverty Centre, who supported the formulation of this module, along with its companion modules, gave comments on its contents and helped edit it. I am also grateful for comments received on an earlier version of this module that was presented at the UNDP Workshop on Pro-Poor Macroeconomic Policies and the MDGs, supported by the Regional Bureau for Africa and the Bureau for Development Policy, in Dar Es Salaam, 20-25 June 2005. This module draws upon, and develops, UNDP research on pro-poor macroeconomic policy, especially Chandrasekhar (2004), Chowdhury (2004), Saad-Filho (2005a) and Roy and Weeks (2003).
2. Milanovic (2003, p. 679), emphasis added.
3. See McKinley (2005a) and (2005b).
4. For an overview of Keynesian policies and the neoclassical synthesis, see Screpanti and Zamagni (1993, ch.7).
5. For a review of this period, see Campbell (2005), Clarke (1988) and Marglin and Schor (1990).
6. For a review of monetarism, see Screpanti and Zamagni (1993, ch.9).
7. See Carlin and Soskice (1990) and Levacic and Rebmann (1982).
8. Policy rules are predetermined policies that ignore changes in circumstances due to the economic cycle or to other shifts in the economic 'fundamentals'. Adherence to rules supposedly reduces distortions and facilitates market-based economic stabilisation in the long-run. In contrast, policy discretion allows the government to decide its policy responses in the light of concrete problems and events, and to shift policies at its convenience.
9. Crowding out is the process by which expansionary fiscal policy financed through the sale of government securities causes the real interest rate to rise and, therefore, private investment to fall.
10. Monetary policy is accommodating when, in a fiscal expansion, the central bank increases the supply of money in order to prevent the real interest rates from rising. This means that the central bank is, in effect, printing money to finance the government deficit (monetisation).
11. FP is not the only or even the first model to look at the conditions for macroeconomic equilibrium in an open economy (for alternative models, see any textbook of international finance). However, for reasons of space, only FP will be reviewed in this Module.
12. This is a simplified presentation of this model. For a more sophisticated analysis, see Fine (2005) and Tarp (1993).
13. See, for example, Milanovic (2003) and McKinley (2001).
14. See, for example, Argitis and Pitelis (2001) and Chang and Grabel (2004).
15. Argitis and Pitelis (2001, p.633) have shown that lower interest rates can raise the industrial profit share, reduce production costs and inflation, and improve competitiveness. This less restrictive economic environment can promote investment, productivity and growth.
16. See, for example, Chang (2003), Chang and Grabel (2004, ch.9), Epstein, Grabel and Jomo (2003) and Kaplan and Rodrik (2000).
17. MacEwan (2003).
18. This part draws upon Chandrasekhar (2004).
19. See Aybar and Lapavitsas (2001), Demigurç-Kunt and Levine (1999), Levine (1997) and Zysman (1983).
20. There is an extensive debate in the literature about these relationships. See, for example, Arestis and Sawyer (2006) and Chowdhury (2004).
21. See, for example, Agénor (2001), Bernanke and Mishkin (1997, pp.106, 109) and Fischer, Sahay and Végh (2002, p.876-7).
22. See Pollin and Zhu (2005).
23. Forder (n.d.).
24. This suggestion made by Joseph Stiglitz is cited by Forder (n.d.).
25. See, for example, Bruno (1985), Bruno and Easterly (1996), Chang and Grabel (2004, ch.11), Dornbusch and Fischer (1991) and Pollin and Zhu (2005).
26. See Forder (2003, pp.16-17) .
27. See McKinley (2003) and McKinley (2005b).
28. For an overview of these arguments, see Pasha and Palanivel (2004, p.13) and Sahay, Cashin and Mauro (2001, p.6).
29. See Chowdhury (2004).
30. Sahay, Cashin and Mauro (2001, p.6) claim that although inflation erodes the poor's wages, the confiscation of their savings is **not** especially serious because they hold little cash.
31. See, for example, Garuda (2000), Pastor (1987) and Vreeland (2002).
32. See Chowdhury (2004).

33. See Chowdhury (2004).
34. See Stiglitz (2002) on how high interest rate policy can cause corporate distress.
35. See Bulíř (2001) and Pasha and Palanivel (2004, pp.14-15).
36. Chang and Grabel (2004, pp.183).
37. The following countries are full-fledged inflation targeters: Australia, Brazil, Canada, Chile, Colombia, Czech Republic, Hungary, Iceland, Israel, Mexico, New Zealand, Norway, Peru, Philippines, Poland, South Africa, Republic of Korea, Sweden, Thailand and the United Kingdom (see Carare and Stone 2003 and Stone and Bhundia 2004).
38. Focus on the policy horizon (achieving the IT in the future, rather than now) avoids the need to make sharp policy adjustments every time supply or demand conditions change, which could be destabilising.



Copyright© 2007

**International Poverty Centre  
United Nations Development Programme**

### **Rights and Permissions**

All rights reserved.

The text and data in this publication may be reproduced as long as the source is cited.  
Reproductions for commercial purposes are forbidden.

The International Poverty Centre disseminates these **Training Modules** to encourage capacity development on economic policies. These studies are signed by the authors and should be cited accordingly. The findings, interpretations, and conclusions that they express are those of the authors. They do not necessarily represent the views of the International Poverty Centre, IPEA or the United Nations Development Programme, its Administrator, Directors, or the countries they represent.

**Training Modules** are available online at <http://www.undp-povertycentre.org> and subscriptions can be requested by email to [povertycentre@undp-povertycentre.org](mailto:povertycentre@undp-povertycentre.org)

---



### **International Poverty Centre**

SBS – Ed. BNDES, 10º andar  
70076 900 Brasilia DF  
Brazil

[povertycentre@undp-povertycentre.org](mailto:povertycentre@undp-povertycentre.org)  
[www.undp-povertycentre.org](http://www.undp-povertycentre.org)  
Telephone +55 61 2105 5000  
Fax +55 61 2105 5001