Appendix 1:

Debates on the Impact of Specific Macroeconomic Policies on Poverty

I. Introduction

We categorize specific macroeconomic policies into fiscal, monetary, financial, exchange rate, and trade policies. Even though these policies are neither independent from each other nor independent from international policy settings we will outline the key debates on the impact of these policies on poverty under these five specific headings, depending on where the concentration of a debate takes place. The last section provides a short conclusion of these various debates, which is also provided in Section B.III.3. of the Strategy Paper. 54

II. Impact of Fiscal Policy on Poverty

Fiscal policies constitute one of the most important domains of the state to reduce poverty. There is broad agreement that (i) an increase in the share of priority sectors (especially education and health), and (ii) a better targeting of public expenditures are essential elements of any poverty reduction strategy. 55 There is also some agreement that steps towards people-centered budgets would support these changes within an overall framework of a fully-participatory poverty reduction strategy. 56 Finally, there is now also broad agreement that the poor need to be protected from contractionary fiscal policies imposed by stabilization programs, though there are of course disagreements about the contents and extent of such a protection.

With regards to fiscal expenditures, various disagreements are related to the trade-offs from choosing between competing expenditures, which should be based on the relative effectiveness of the different expenditures to reduce poverty. Most of these trade-offs can only be assessed properly by analyzing the impact of various expenditures on poverty using detailed information based on repeated household surveys. In any case, one aspect that deserves more attention is the protection of the poor from economic shocks.

54 Note also that the bibliography for this appendix is part of the comprehensive bibliography provided in the last section of the Strategy Paper.


56 Recent studies analyzing the benefit incidence of public expenditures indicate that the poor do not get their fair share of these expenditures. For example, Castro-Leal, Florencia, Julia Dayton, Lionel Demery, and Kalpana Mehra, “Public Social Spending in Africa: Do the Poor Benefit?” World Bank Research Observer, Vol. 14, No. 1 (February 1999), pp. 49-72 show that the benefit incidence of public spending on health for the poorest 20 percent of the population is 11 percent for Cote d’Ivoire, 12 percent for Ghana, 4 percent for Guinea, 14 percent for Kenya, 12 percent for Madagascar, 17 percent for Tanzania, and 16 percent for South Africa.

The literature analyzing the impact of economic shocks on the poor seems to indicate that the poor are more vulnerable to economic shocks than the non-poor.\textsuperscript{58} Though vulnerability is generally cited as a companion of material and human deprivation, which emerges as a result of internal and external macroeconomic instability (which the poor are unable to avoid, mitigate, or cope with), the protection of the poor from economic shocks is likely to have some immediate budgetary consequences. Furthermore, given that most developing countries have pro-cyclical government expenditures, the protection of the poor from economic shocks could also have medium-term budgetary implications. For example, it could be considered to establish reserves during high-growth periods that could be used to buffer shocks during low-growth periods, especially for the poor and most vulnerable groups of society.

With regards to fiscal revenues, there are various disagreements on what changes in tax policies (for example, changes in the tax progression) will benefit the poor most in the long run.\textsuperscript{59} As was the case on the expenditure side, these policy choices can only be assessed properly by analyzing the impact of various tax policies on poverty using detailed information based on repeated household surveys, which is complicated by issues related to changes in foreign tax structures and capital mobility. In any case, there is some agreement that tax codes should be simplified and that tax exemptions to the non-poor policies should be eliminated.

Finally, looking at the combination of expenditures and revenues, there are debates on (i) what levels of budget deficits are sustainable (which depends for most of the developing countries critically on the availability of foreign budget assistance in terms of loans and grants) and (ii) how to finance budget deficits without compromising macroeconomic stability. The first question has been addressed in Section B.III.4.a. of the Strategy Paper; the second question will be discussed in the next section.

\section*{III. Impact of Monetary Policies on Poverty}
While there is broad agreement that high and highly volatile inflation has negative implications on growth and poverty, there is no agreement on the impact of moderate inflation on poverty and growth. With regards to the impact of inflation on poverty, there are only a couple of cross-country studies (see Section II.3.a. of the Bibliography), indicating that high inflation increases poverty, largely through (a) the negative impact of high inflation on economic growth and (b) the lack of the poor to protect the real value of

\textsuperscript{58} See Ferreira, Francisco, Giovanna Prennushi and Martin Ravallion, “Protecting the Poor from Macroeconomic Shocks” World Bank, Policy Research Working Paper, No. 2160 (August 1999); and Glewwe, Paul and Gilette Hall, “Are some Groups more Vulnerable to Macroeconomic Shocks than Others? Hypothesis Tests on Panel Data from Peru” \textit{Journal of Development Economics}, Vol. 56, No. 1 (June 1998), pp. 181-206. Note that though the analysis of Easterly, William, “The Effect of IMF and World Bank Programs on Poverty” IMF, First Annual Research Conference (November 2000) seems to indicate that the poor may suffer less from economic shocks in countries undergoing structural adjustment reforms, it has been pointed out that this result could be due to 5-year observation period and that higher frequency data would show that the poor suffer more during crises.

\textsuperscript{59} Tanzi, Vito and Howell H. Zee, “Tax Policy for Emerging Markets: Developing Countries” Washington, DC: IMF Working Paper, WP/00/35 (March 2000) have cautioned against increasingly progressive taxes as they could have negative implications on investment and growth.
their incomes and assets from inflation. Easterly and Fischer (2000) conclude that their evidence tends to support the view that inflation reduces the relative income of the poor. Based on correlating inflation with the share of the bottom quintile in income, the poverty rate, and the real minimum wage, they find that high inflation tends to (i) lower the share of the bottom quintile, (ii) lower the real minimum wage, and (iii) increase poverty. However, more recently, Cashin, Mauro, Pattillo, and Sahay (2001) have found no evidence that inflation (or its variance) is individually associated with either pro-poor or anti-poor economic growth.

With regards to the impact of inflation on growth, most of the literature indicates that the negative relationship between inflation and growth applies only to high inflation. However, Gosh and Phillips (1998) concluded that inflation has at all but the lowest levels a negative impact on growth. As was the case in the growth-poverty debate, some more insights could be obtained by looking beyond average relationships between inflation and poverty. Indeed, a recent study by Khan and Senhadji (2001, p. 1) suggested that “the threshold level of inflation above which inflation significantly slows growth is estimated at 1-3 percent for industrial countries and 11-12 percent for developing countries.”

Furthermore, there is a considerable debate on what constitutes a proper stabilization of inflation. In addition to the question to which level inflation rates should be at or reduced to, there are questions on how aggressively inflation rates should be reduced, under what circumstances inflation rates should be reduced, and what instruments should be used to stabilize inflation. According to these four issues, critiques claim that IMF-supported disinflations (i) target unnecessarily low inflation rates, (ii) are performed too aggressively, (iii) neglect an economy’s business cycle, and (iv) use inappropriate instruments. We will return to some of these issues below when we discuss debates related to exchange rate policies.

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IV. Impact of Financial Policies on Poverty

Until recently, financial policies have not been considered to be key components of poverty reduction policies. However, events like the rise of micro-finance on the one hand and the East Asian crisis on the other hand, have brought financial policies to the center of the development debate. Though the East Asian Crisis has shown that there is a connection between weaknesses in the domestic banking sector, financial liberalization and currency crisis, we first review debates that concentrate on domestic financial polices and summarize then the debate on financial liberalization.

IV.1. Domestic financial policies

As demonstrated in a recent World Bank policy research report, there is broad agreement that a sound financial sector is crucial for poverty-reducing economic growth. There is less agreement on the report’s conclusion that governments are not good at providing financial services and that developing countries should tap market forces so that bank owners, participants in the financial markets, and bank supervisors have incentives to monitor one another and avoid excessive risk. On the other hand, there is again broad agreement that (a) well functioning markets need legal and regulatory underpinnings, (b) good financial safety nets require good institutions, and (c) a diversity of financial intermediaries is good for financial stability and development. The more difficult questions are what legal and regulatory underpinnings are needed, how to get good institutions and a diversity of financial intermediaries, whereby the key debate is on the impact of capital account liberalization.

IV.2. The debate on the impact of financial liberalization

Though the benefits and costs of financial liberalization have been debated for decades, the majority of the recent literature (please see Section II.3.b. of the Bibliography) comes to the conclusion that financial liberalization has gone too far and been too fast for most of the developing countries.

Cobham (2001) provides a summary of the literature on the growth impacts of capital account liberalization, reviews the impacts of capital account liberalization on government spending, and considers whether financial liberalization brings benefits to the poor through greater employment opportunities and access to credit. Cobham concluded that while theory implies there will be efficiency benefits for international finance, the existence of growth benefits for developing countries has simply not been established. Similarly, Blecker (1999, p. xiv) concluded that although more research is

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67 Cobham, Alex, “Capital Account Liberalisation and Poverty” Paper prepared for an expert group meeting held at Oxford University, January 2001; published as Part II of a joint Bretton Woods and Oxfam report examining the links between capital account liberalization and poverty, which is available on the internet: http://www.brettonwoodsproject.org/topic/financial/f22growthflows1.htm.
clearly needed, “on the whole, the costs of capital market liberalization have generally outweighed the benefits.”

The World Bank’s research report on *Finance and Growth* (2001, p. 4; see footnote 12) has stated that open financial markets can spur development, but also warned that “opening up is accompanied by some drawbacks, including a heightening of risk in some dimensions, and will need careful monitoring.” The IMF study on capital account liberalization has also acknowledged that liberalizing the capital account before the developing country’s financial system has been strengthened can contribute to serious economic problems, however, the study nevertheless concludes that financial liberalization is inevitable for countries that wish to take advantage of the substantial benefits of participating in the open world economic system.

A more recent IMF working paper by Wagner (2001) has found that the many structural changes that are associated with the globalization process cause an increase in the uncertainty surrounding monetary policy which leads to increased uncertainty as to how to interpret macroeconomic data and about the monetary transmission mechanism. On the other hand, Wagner concluded that globalization increases international competition that forces market players to make structural adjustments or reforms that change the conditions or constraints under which monetary policy is implemented.

Finally, though also recognizing that liberalization may bring some benefits, Wyplosz (2001) concluded that a silver lining of the recent crises is that the liberalization activism of the 1990s is now passé, and that there is no urgency to undertake liberalization, even though that step should be taken somewhere down the road.

V. Exchange Rate Policy

While the key debates related to exchange rates are ongoing since the collapse of the so-called Bretton Woods exchange rate system, there are also a couple of debates related to national exchange rate policies. A first debate is related to a country’s overall choice of exchange rate regime, a second debate is related to the optimal adjustment of a country’s exchange rate, and a third debate is related to measures a country could adopt to limit the negative implications of devaluations on the poor.

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72 For instance, if the world should return to a fixed exchange rate system or if the negative effects of speculative capital movements can be limited through a global tax on international currency transactions (the Tobin tax).
V.1.  The choice of an appropriate exchange rate regime

It is now conventional wisdom that a country’s choice between a fixed and a flexible exchange rate depends on balancing the effectiveness of and need for an independent monetary policy with that of limiting excessive volatility of exchange rates under flexible regimes. However, there are disagreements on the size of the negative impacts of exchange rate volatility. Over the last three decades, encouraged by the IMF, more and more developing countries have adopted more flexible regimes. Though Fischer (2001)\(^{73}\) has shown that the actual number of developing countries that have adopted a flexible exchange rate regime is lower than the number of countries that officially declared to have a flexible exchange rate regime, there remains a trend towards more flexible exchange rate regimes.

One of the key reasons for the move towards flexible exchange rate regimes has been related to the unsuccessful experience with fixed regimes, which are at least partly due to inertia in required adjustments based on an excessive accommodation to political pressures. The adoption of a flexible exchange rate regime is considered to reduce the latitude for discretion and political pressure on the conduct of exchange rate policy, which led to considerably overvalued exchange rates in the 1980s. While a flexible exchange rate regime implies by definition continuous changes in the exchange rate, experience has shown that a fixed exchange rate regime usually implies mega-devaluations that occur once the fixed exchange rate regime collapses. Though disagreements remain, there is some indication that the move toward more flexible exchange rates has been associated with large declines in economic rents and a shift of relative prices that favor the rural poor.\(^{74}\) We will discuss this further in the subsection on the impact of devaluation on the poor.

More generally, macroeconomic theory suggests that a fixed exchange rate would require a country to (i) have a dominant trade share (at least 50 percent) with the country or countries to which the currency is fixed, and (ii) be able to sustain an inflation rate consistent with the currency or basket of currency to which the peg is made. Another key economic argument for flexible exchange rates is the claim that a flexible regime can smooth adjustment to real shocks more effectively than a fixed regime.\(^{75}\) Hence, a key decision rule is not based on which regime provides a more stable real exchange rate, but which regime is more appropriate to cope with external shocks. Moreover, Tornell and Velasco (2000)\(^{76}\) have shown that fixed exchange rates do not necessarily imply more


\(^{75}\) For one of the most recent and comprehensive evidence along this line, see Broda, Christian, “Coping with Terms-of-Trade Shocks: Pegs versus Floats”, *American Economic Review*, Vol. 91, No. 2 (May 2001), pp. 376-80.

fiscal discipline than flexible regimes. Finally, based on an analysis of 22 SSA countries from 1980-96, Adam, Bevan and Chambas (2001)\textsuperscript{77} suggested that misalignments of the real exchange rate imply lower fiscal revenues, though this is not necessarily an argument for flexible exchange rates.

While most of these factors tend to suggest that a flexible exchange rate regime seems to be slightly more consistent with sustained economic growth and poverty reduction strategies of small developing countries than the adoption of a fixed exchange rate, the temporary adoption of a fixed exchange rate may be a successful short-run strategy, especially if inflation is caused by volatile external factors (like temporary terms of trade shocks and unusual large capital inflows).

V.2. Determination of the optimal adjustment of a country’s exchange rate

Independent on which exchange rate regime is adopted, the question usually arises on what the optimal adjustment of the nominal exchange rate is. With fixed nominal exchange rates, the question is at which point to correct any possible deviation from the real exchange rate. In this regards, the use of a high interest rate policy to defend a fixed exchange rate regime (as suggested by the IMF for some of the East Asian countries) has come under severe attack.

With flexible exchange rates, the question on the optimal adjustment of the exchange rate implies the determination of the optimal degree of exchange rate flexibility. Given that the adoption of fully market-determined exchange rate is generally associated with excessive exchange rate volatility, especially in small developing countries, it is generally agreed that interventions aiming at reducing excessive volatility are principally desired as long as these interventions do not intend to defend any particular rate that is inconsistent with the long-term equilibrium exchange rate. Nevertheless, the IMF usually suggests an exchange rate policy of strict non-intervention in the setting of the exchange rate, and to forego all discriminatory currency practices and exchange restrictions.

V.3. Impact of devaluation on poverty

In general, devaluations are quite unpopular within developing countries, largely due to (i) fears of setting off a devaluation-inflation spiral, (ii) low export and import elasticities, (iii) increased domestic costs of servicing foreign debt, (iv) increased costs of financing subsidies for imported inputs, (v) falling terms of trade, (vi) fear of a loss of confidence with foreign investors, and (vii) for many other political reasons.

Most of the early literature also indicated that devaluations have negative impacts on the poor, mainly through its negative impact of inflation. Stabilization programs, in which devaluations usually were a key component, were harshly criticized in circles associated with the poor, especially among NGOs. For a more advanced analysis of the

impact of devaluation on poverty, see for example, Stewart (1995). While no clear conclusion has emerged yet, there are a couple of recent studies that seem to indicate that devaluations had generally a positive impact on poverty reduction. In any case, it is clear that a further disaggregation of the effects and of the poor is needed, i.e., into short-term and long-term effects, and into rural and urban poor.

VI. Trade Policy

The recent empirical literature analyzing the impact of trade specifically on poverty seems to conclude that trade has a positive impact on poverty reduction. Furthermore, the majority view among economists suggests that recent changes in the distribution of income primarily reflects technological changes rather than increases in international trade. Thus, the general conclusion is that further trade liberalization will have an overall positive impact on poverty reduction. However, it has also been argued that there are methodological problems with the empirical strategies employed in the trade literature which cast doubt on the majority view that countries with lower policy-induced barriers to international trade grow faster (see Rodriguez and Rodrik 2000). Furthermore, as Winters (April 2000) has shown, there are cases in which the poorest members of society have been negatively affected from trade liberalizations, and thus, compensatory policy measures may be needed. Studies that disaggregate among the poor show that depending on production, trade, and consumption patterns, some of the poor are positively, and some negatively affected by trade. Furthermore, studies that disaggregate trade liberalizations into various components indicate that some agreements (e.g., free trade of goods) will generally benefit the developing countries, while other agreements (like on intellectual property rights) will be costly for most of the least developed countries. There is also evidence that there are “Rigged Rules and Double Standards” which prevent world trade from being a powerful motor to reduce poverty.

78 Stewart, Frances, Adjustment and Poverty: Options and Choices, London and New York: Routledge, 1995. This analysis is based on (a) changes in the price ratio between tradeables and non-tradeables, (b) the relative labor intensity between tradeables and non-tradeables, and (c) the distribution of poverty among urban and rural sectors.


81 See the forthcoming Trade Report of Oxfam International (April 2002); which will also be available on the Oxfam International website (http://www.oxfam.org/).
A factor that has been neglected widely is the possible negative implications from international implications. If all developing countries try to benefit from increased food exports, the likely effect will be a further collapse of food commodity prices, and the projected benefits to the rural poor from such a strategy may thus not occur. See Blecker (2000) for a thorough analysis of the related issue of diminishing returns to export-led growth. Finally, Cagatay (2001) has pointed out that (a) men and women are affected differently by trade policies and performance, owing to their different locations and command over resources within the economy, (b) gender-based inequalities impact differently on trade policy outcomes, depending on the type of economy and sector, with the result that trade liberalization policies may not yield expected results, and (c) gender analysis is therefore essential to the formulation of trade policies that enhance rather than hinder gender equality and human development.

VII. Conclusion

The various debates on the impact of specific macroeconomic policies on poverty have shown that such an analysis implies a marriage between macroeconomics and microeconomics that is still at an early stage. Indeed, a recent IMF Working Paper by Cashin, Mauro, Pattillo, and Sahay (September 2001, p. 21; please see footnote 7 for full references) has not found significant and robust evidence that variables such as inflation, budget deficits, government spending, openness, and the black market foreign exchange premium are individually associated with pro-poor (or anti-poor) economic growth, and has thus called for alternative research approaches to find significant and robust evidence on the direction and strength of the effects of these variables on the poor.

Furthermore, even the impact of IMF-supported stabilization programs on growth is still highly disputed. Przeworski and Vreeland (2000) find that (i) IMF programs lower growth rates for as long as countries remain under a program, and (ii) once countries leave the program, they grow faster than if they had remained, but not faster than they would have without the IMF program. Similarly, Barro and Lee (2001) find that without instrumenting, increased IMF program participation is associated with a contemporaneous reduction of economic growth, though they find no statistically significant contemporaneous impact of IMF program participation after controlling for endogeneity. With regards to recent currency crises and the current Argentine debt crisis, the question has been raised if the output costs of IMF-suggested macroeconomic policies

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and their impact on the poor are worse than the initial disease. While there is some broad agreement that macroeconomic stability is necessary for sustainable growth and poverty reduction, there is little agreement on what constitutes macroeconomic stability.

Finally, there also remain sharp disagreements on how to define and maintain macroeconomic stability, especially in already slow-growing or stagnating economies. While the United States is currently encouraging other countries to use more expansionary fiscal and monetary policies to overcome the current slump of the world economy, almost all IMF-supported programs prescribed some contractionary fiscal and monetary policies, even if these countries were in the midst of economic stagnation.