

Policy space and the changing paradigm in conducting macroeconomic policies in developing countries

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1. Introduction

A stable macroeconomic environment is commonly considered to be conducive to long-term growth. Economists disagree, however, about whether price stability should be the central objective of macroeconomic policies or whether these policies should serve broader development goals. Furthermore, the concept of macroeconomic stability is itself subject to dispute, as reflected in the evolution of macroeconomic thinking and practice over the past quarter century.

In fact, the focus of macroeconomic policies in developing countries has shifted over recent decades. Until the 1970s, these policies were mostly embedded in broad, growth-oriented national development strategies. However, the severe macroeconomic instability that many developing countries have faced since the 1980s has narrowed the focus of macroeconomic policies to lowering inflation and avoiding major fiscal and external imbalances. Coinciding with this narrowing was a paradigm shift in the mainstream approach to macroeconomic policies in the developed countries, away from a Keynesian approach of countercyclical demand management aiming for full employment and towards a more conservative, monetarist view aiming at controlling inflation, which was seen as critical to long-term economic growth. In both developed and developing countries, the concept of short-term economic stability became in practice synonymous with low inflation, leaving aside the *real* dimensions of stability that had been the focus of both development policies (stable, long-term growth) and Keynesian management (smoother business cycles).

This new orthodoxy in macroeconomic policies prevailed during the 1980s and 1990s, but its effectiveness is increasingly being questioned. Though many developing countries managed to reduce inflation and restore fiscal balances by applying such policies, they failed to achieve strong and sustained economic growth. Moreover, the stabilisation policies quite often induced a “procyclical” pattern of macroeconomic policy responses, achieving one dimension of stability (eg low inflation) at the cost of others (eg stronger business cycles). A fundamental reason for the incapacity to achieve sustained economic growth is that procyclical adjustment typically damages public and private investment and thereby economic growth.

Critics of this framework have called for a return to the broader, developmental approach to macroeconomic stabilisation policies that are based on an integration of short-term, countercyclical fiscal and monetary measures with long-term development policies (see eg Ocampo (2005); Stiglitz et al (2006)). They stress that macroeconomic policies should be growth-centred, with full employment as the ultimate objective. They also argue that because

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of differences in development level, quality of institutions, and degree of vulnerability to global macroeconomic and financial instability, the macroeconomic policy framework for developing countries could also differ in substantial ways from that in developed economies.

The broader approach to macroeconomic policies and its links with other economic policies (eg, production sector and trade strategies) is also needed because the nature of the growth process differs between developed and developing countries. In developed countries, productivity growth relies mainly on technological innovation. In contrast, developing countries can achieve productivity growth by shifting the labour force from low- to high-productivity sectors. As this process directly influences investment decisions and resource allocation, the impact of macroeconomic policies on growth will be stronger in developing than in more developed economies.

In this context, a critical question is how much “policy space” developing countries have to adopt autonomous and effective countercyclical macroeconomic policies consistent with longer-term development objectives. Many policy analysts feel that, with deeper integration into global markets, developing countries have lost such space.

Trade and terms-of-trade fluctuations have historically played a major role in the determination of business cycles in developing countries, particularly in commodity-dependent economies. The widespread shift towards export-led strategies in the developing world has actually accentuated this dependence in all countries. Domestic policies quite often respond procyclically to commodity price volatility, among others, by expanding fiscal expenditures during the boom and reducing spending when prices are down. The latter is reinforced by the conditionality linked to international financial assistance during crises, which involves orthodox macroeconomic stabilisation policy packages.

In many middle-income countries, in turn, business cycles have increasingly been influenced by *capital* account fluctuations. Strongly procyclical fluctuations in private capital markets are transmitted through public sector accounts, especially through the effects of available financing on government spending and through the effects of interest rates on the public debt service. But the stronger effects typically run through private spending and balance sheets. During booms, private sector deficits and borrowing tend to rise and risky balance sheets accumulate, riding on perceived “success”, typically seen to be reflected in low risk premia and spreads. Reversals in such perceptions lead to a cutoff from external financing and provoke sudden increases in the cost of borrowing, inducing downward adjustment. Developing country governments are then forced to adopt procyclical macroeconomic policies that reinforce the cyclical movements in financial markets. Indeed, during crises, the reputation and credibility of the government are judged by financial market agents according to its capacity to reduce emerging instability by containing inflation and fiscal deficits. This may set off a vicious circle between increased (country) risk premia, reduced availability of financing, and increasing restrictive fiscal and monetary policies, which can be particularly destabilizing in economies with high debt ratios (see eg Frenkel (2005)). At the same time, rising borrowing costs and rationing of credits in financial markets generate strong procyclical responses from market agents. Unstable external financing thus induces procyclical behaviour of both private agents and macroeconomic policies, which would suggest – in the words of Stiglitz (2003) – that Keynesian automatic stabilisers have been replaced with automatic destabilisers.

This paper argues that a more developmental and growth-friendly approach to macroeconomic policies in developing countries requires measures to mitigate the procyclical effects of financial markets, provide more stable aid inflows, deepen financial markets and strengthen domestic financial governance structures. Such conditions will create “policy space” for countercyclical macroeconomic policies.

Part 2 of this paper argues that procyclical macroeconomic policies in developing countries are associated with lower long-term economic growth because they generate greater volatility and uncertainty in the real economy. Part 3 discusses some key factors, both

external and domestic, that determine procyclicality in the macroeconomic policy decisions. Part 4 suggests a number of domestic and international actions that could be undertaken to enhance the macroeconomic policy space.

2. The cyclicity of macroeconomic policies in developing countries

The recent empirical growth literature has found increasing evidence that the way in which macroeconomic policies are conducted can have important implications for long-term growth. Aghion and others, for example, show that countercyclical policies can directly influence long-term growth (see Aghion and Howitt (2005); Aghion et al (2006)). When firms are financially constrained, an economic downturn would force them to cut investment, hampering growth in the long run. However, if the government has the fiscal space to increase public expenditures, reduce taxes, provide subsidies to private enterprises for long-term investment or relax the monetary stance during an economic downturn, the adverse impact on long-term investment and growth would be reduced.

In practice, however, macroeconomic policies in developing countries tend to be procyclical – exacerbating, rather than alleviating, the adverse impact of the downturns on long-term growth. In this regard, differences in the capacity of governments to conduct countercyclical policies could be a contributing factor to differences in growth among these countries.

Policy cyclicity is defined as the policy stance in relation to the growth rate of the economy. For example, fiscal policy is countercyclical when expenditures are increased and/or tax rates are decreased to counteract downturns in the economy and expenditures are decreased and tax rates increased when the economy is expanding.

Kaminsky et al (2004) examine the cyclicity of monetary and fiscal policies in a sample of 104 developed and developing countries for the period 1960–2003.² According to an index constructed as the weighted average of cyclicity in public expenditure and tax rates, Rwanda and Oman had the most procyclical fiscal policies, while Finland had the most countercyclical. The study found that, in general, macroeconomic policies tend to be procyclical in developing countries and countercyclical in developed economies. In particular, fiscal policy in Africa and Latin America has been highly procyclical while in the fast-growing economies in East Asia, fiscal policies have been either neutral to the business cycle or countercyclical (see Table 1).

There is, in turn, a strong negative correlation between procyclical fiscal behaviour and the rate of long-term growth when measured for a large sample of developing countries (see Figure 1), although there are important outliers. The direct link between the cyclicity of monetary policy and growth is much weaker, partly because of the technical difficulty in defining a proper cyclical index for monetary policy across all countries given the different monetary policy regimes.³

² Policy cyclicity is defined more specifically here as the correlation between the cyclical measure of a specific policy stance and the cyclical measure of GDP growth. The Hodrick-Prescott filter is the commonly used approach to isolate the cyclical from the “structural” component of the trends in output growth, fiscal spending, taxation and monetary variables.

³ Compared to fiscal policy, it is more difficult to find a common measurement of monetary policy stance for all the countries, as some countries target the aggregate money supply, others target the interest rate and yet others target the exchange rate.

Table 1

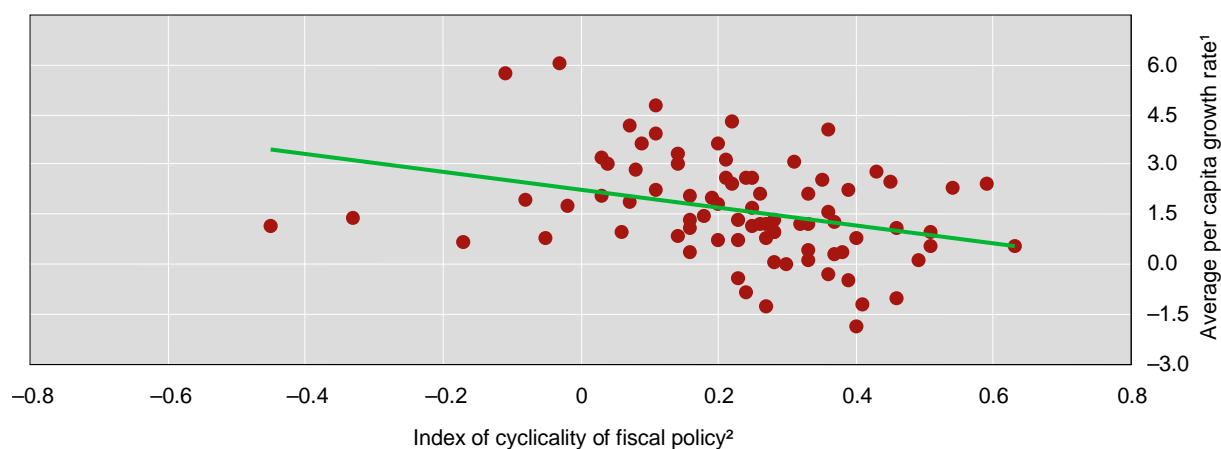
Cyclicality of fiscal policy and economic growth 1960–2003

Region/country	Cyclicality of fiscal policy (index)¹	Average GDP per capita growth rate (in %)
Africa	0.30 (highly procyclical)	1.1
Cameroon	0.51 (highly procyclical)	1.0
Côte d'Ivoire	0.38 (highly procyclical)	0.4
Kenya	0.26 (highly procyclical)	1.2
Rwanda	0.63 (most procyclical)	0.5
Latin America	0.25 (highly procyclical)	1.2
Argentina	0.28 (highly procyclical)	1.0
Brazil	0.22 (highly procyclical)	2.4
Colombia	–0.02 (acyclical)	1.8
Mexico	0.19 (moderately procyclical)	2.0
Peru	0.40 (highly procyclical)	0.8
Venezuela	0.36 (highly procyclical)	–0.3
Asia	0.16 (moderately procyclical)	3.3
Fast growing Asia	0.06 (acyclical)	4.4
China	–0.03 (acyclical)	6.1
Indonesia	0.09 (procyclical)	3.6
Korea, Republic of	–0.11 (countercyclical)	5.8
Malaysia	0.11 (procyclical)	4.0
OECD	–0.11 (countercyclical)	2.6
Finland	–0.51 (most countercyclical)	2.9
France	–0.24 (highly countercyclical)	2.5
Germany	–0.02 (acyclical)	1.9
Japan	0.05 (acyclical)	4.0
United Kingdom	–0.37 (highly countercyclical)	2.2
United States	–0.19 (moderately countercyclical)	2.2
High-to-middle income developing countries	0.28 (highly procyclical)	2.8
Middle-to-low income developing countries	0.17 (moderately procyclical)	2.0
Low-income countries	0.28 (highly procyclical)	1.0

¹ The index is constructed as a weighted average of indicators of fiscal policy cyclicality, which include public expenditure, a proxy for changes in tax rates and changes in expenditures over the business cycle in 104 countries. The index ranges from –0.51 to 0.63 where positive figures denote higher procyclicality and negative numbers, the level of countercyclicality. For more details, see Kaminsky et al (2004).

Source: United Nations (2006): Table IV.2.

Figure 1
Cyclicality of fiscal policy and economic growth in developing countries
 1960–2003



¹ In per cent. ² Weighted average of indicators of fiscal policy cyclicality, including public expenditure, a proxy for changes in tax rates and changes in expenditure over the business cycle; positive figures denote higher procyclicality and negative numbers the level of countercyclicality. For more details see Kaminsky et al (2004).

Sources: UN (2006): Ch IV based on data by Kaminsky et al (2004); World Bank (2005), *World Development Indicators*.

In the face of volatile capital flows, exchange rate policies generate additional complications. A stable nominal exchange rate can provide an anchor for general price stability, which may be particularly useful for countries with a history of high inflation. Nonetheless, an exchange-rate peg limits or even eliminates manoeuvring room for conducting countercyclical monetary policies. Furthermore, strong speculative pressures during periods of sudden stops of external financing have made it more difficult for developing countries to maintain a fixed exchange rate regime, as attested by the various currency crises that occurred in countries that held on to a fixed peg.

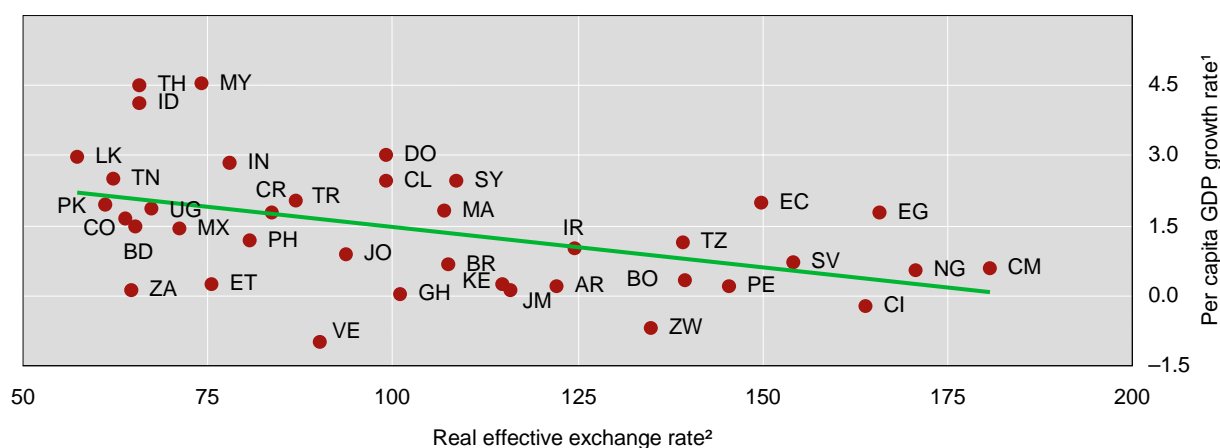
In response, many developing countries have moved towards more flexible exchange rate regimes. But flexible exchange rates are no panacea. One of the major risks that they pose is that of overvaluation during periods of capital surges and/or favourable terms of trade, as well as of overshooting depreciations during crises. Flexibility may thus result in excessive exchange rate volatility through the business cycle, which reduces the benefits from international specialisation. These disadvantages help explain why the move towards exchange rate flexibility has generally been mixed in the developing world, with some degree of central bank intervention in foreign exchange markets (often referred to as “dirty floats”).

Governments in these developing countries intervene in foreign exchange markets primarily to promote export competitiveness, targeting the real exchange rate. Aside from the strictly countercyclical reasons for such interventions, there may be long-term justifications: maintaining some level of exchange rate stability and competitiveness through the business cycle generates incentives to invest in export-oriented industries and creates more stable signals to allocate investment between tradable and non-tradable sectors.

Indeed, countries that were able to maintain a relatively stable and competitive real exchange rate seem to have fared better in terms of economic growth. Figure 2 shows the average degree of real exchange rate “appreciation” (or “overvaluation”) measured as the deviation of the purchasing power parity (PPP) of each country’s currency with respect to the United States dollar and adjusted for the difference in productivity growth of the country with respect to that of the United States. The countries in sub-Saharan Africa and Latin America are predominantly clustered in the lower-right part of the figure, indicating a combination of

an appreciated real exchange rate and lower growth. East and Southeast Asian countries are typically found in the upper-left quadrant, showing an association between more competitive exchange rates and higher economic growth. Exchange rate policies in most of these countries supported industrial and commercial policies to promote export-led growth.

Figure 2
Real effective exchange rate overvaluation and per capita GDP growth rate, selected economies
 1970–2003



AR = Argentina, BD = Bangladesh, BO = Bolivia, BR = Brazil, CI = Côte d'Ivoire, CL = Chile, CM = Cameroon, CO = Colombia, CR = Costa Rica, DO = Dominican Republic, EC = Ecuador, EG = Egypt, ET = Ethiopia, GH = Ghana, ID = Indonesia, IN = India, IR = Iran, JM = Jamaica, JO = Jordan, KE = Kenya, LK = Sri Lanka, MA = Morocco, MX = Mexico, MY = Malaysia, NG = Nigeria, PE = Peru, PH = Philippines, PK = Pakistan, SV = El Salvador, SY = Syria, TH = Thailand, TN = Tunisia, TR = Turkey, TZ = Tanzania, UG = Uganda, VE = Venezuela, ZA = South Africa, ZW = Zimbabwe.

¹ In per cent, using data at 1990 US dollars for calculations. ² Values greater than 100 denote overvalued (appreciated) currencies and values less than 100, undervalued (depreciated) currencies.

Sources: United Nations Statistics Division; *Global Development Network Growth Database*, Development Research Institute, New York University.

The costs of procyclical policies for many developing countries are high. In the upturns, procyclical macroeconomic policies, such as imprudent fiscal spending, can lead to inefficient resource allocation, in some cases contributing directly to overheating in the economy and sowing the seeds for macroeconomic instability. In the downturns, procyclical policies, such as over-tightening of monetary policy and indiscriminate fiscal adjustments, can lead to substantial losses in many valuable social projects, weakening accumulation of infrastructure and human capital as well as aggravating the downturn and reducing the potential for long-term growth.

3. Factors underlying procyclicality in macroeconomic policies

Several factors can cause procyclicality in macroeconomic policies and limit their space to conduct countercyclical policies. Without trying to be exhaustive, we discuss in this section three factors we consider to be of major importance: the pass-through of capital account volatility to the domestic business cycle, including through policy responses; the macroeconomic effects of financial liberalisation in a context of underdeveloped domestic financial markets; and the institutional framework and restrictive rules guiding fiscal and monetary policies. This last factor has often been (self-)imposed to enhance policy credibility –

such as with an inflation-targeting regime – but may at the same time exacerbate procyclical tendencies in an economic adjustment process.

3.1 Capital account volatility and procyclical policy responses

International capital flows to developing countries have been volatile and a major source of macroeconomic instability. Both the availability and the cost of external financing ease during periods of economic expansion, whereas during downswings they tighten and become more expensive. As is well known, two *medium-term* cycles in capital flows had a strong impact on stability and growth in many countries (UN (2005), pp 74–5; UNCTAD (1999), Ch IV). A boom in international bank lending to developing countries in the 1970s ended in debt crises in the 1980s. Another boom took place in the 1990s, which was driven mainly by portfolio investment flows. To a lesser extent, foreign direct investment (FDI) came to an end with a sharp decline in net flows and a sharp rise in emerging market spreads after the Asian and Russian financial crisis of 1997–98. Since 2003, the recovery of private capital flows and the reduction in spreads have progressed at a rapid pace. This boom in external financing, together with other favourable conditions facing developing countries, indicates that we are currently in the midst of a third cycle, which was already subject to temporary and short-lived shake-ups, particularly in May–June 2006 and February and August 2007.

In all cycles, private capital flows to developing countries are concentrated in a small number of middle-income countries, bypassing most low-income countries, which remain dependent on official flows. The source of financing has also changed through time, responding to cyclical factors affecting the world economy, institutional changes in the financial sector of industrial countries and financial liberalisation policies in developing countries.

During the 1970s, the access of developing countries to private financing resulted in part from banks in the developed countries seeking new markets to turn their excess liquidity into profitable loans. The excess liquidity originated from oil surpluses that were largely deposited in the commercial banks, as well as from institutional changes in international financial markets that permitted the entrance of smaller and middle-sized banks that had previously not been allowed to engage in international lending. The increased competition in international lending further pushed down the cost of borrowing. At the same time, however, groups of banks shared risks through syndicated lending, which strengthened the concentration of loans among a few developing countries (see Vos (1994), Ch 5). The middle-income developing countries were seen as a good risk at the time, in part because of their strong export performance and the high commodity prices that prevailed during the 1970s, all of which benefited Latin American and other middle-income primary exporters.

Around 1980, the surge in bank lending came to a sudden stop as world interest rates rose and the perception of risk changed with the sudden increase in the debt-servicing burden of the borrowing countries. The subsequent massive withdrawal of bank loans accelerated the debt crises that spread among the developing countries. The rise in the cost of borrowing and the restriction of access came at a time when commodity prices collapsed and the need for external financing had actually increased.

After 1990, the entrance of new players into the market spurred renewed access to private capital flows. The new players included the pension funds and other institutional investors that had previously been permitted to operate only in domestic financial markets. In addition, the financial liberalisation processes in many developing countries eased the entrance of private capital flows. As mentioned above, much of the lending during this second cycle took the form of portfolio debt and equity investment which, even when formally long-term in character, have been much more volatile than FDI, indicating that market agents are dominated by short-term expectations in the supply of financing and perceptions of risk. Short-term bank loans have proven even more volatile. The Mexican peso crisis at the end of 1994 was good evidence of this volatility, but it was short-lived, thanks to a massive support

package from the United States. In contrast, the situation in East Asia initiated the broad-based series of financial crises in the final years of the decade.

Aside from their strong procyclical features, boom-bust cycles tend to spill over to other markets, generating the phenomenon that has come to be called financial market “contagion” – spreading both optimistic and pessimistic market sentiments, depending on the phase of the cycle. A country’s loss of access to markets for international banks or bonds spreads to other sources of financing (and can even affect market access of other countries), and an across-the-board market closure may follow (UN (2005)). The 1998 Russian crisis is an extreme example of sweeping market closure following a downturn. Even when countries do not fully lose market access, they are subject to increases in risk premia. The procyclical downgrades by credit-rating agencies often exacerbate both reduced access to portfolio loans and the spreads at which bonds can be issued.

With the reversal of short-term capital flows during the Asian financial crisis, FDI was resilient and became the dominant source of private capital flows to developing countries. It is worth noting that FDI also moves procyclically, although not to the same extent as short-term bank loans and portfolio investment (WB (1999)). FDI can also increase macroeconomic instability, in part because much of FDI takes the form of mergers and acquisitions of firms in developing countries, which depend on the procyclical availability of financing for such operations. To the extent that FDI is geared towards the domestic market, it responds to economic booms and downturns in the same way as domestic investment. On the other hand, the retrenchment in cross-border bank lending, the more recent growth of local bond markets in developing countries and the broadening of the investor base of international emerging market bonds have also helped to mitigate the volatility of capital flows in recent years (UN (2005), pp 89–90).

The procyclical nature of private capital flows limits the space for governments to conduct countercyclical macroeconomic policies. As access to finance eases when the economy is in an upswing, governments may be more inclined to allow the budget deficit to widen, and central banks may allow credit to the private sector to expand. Conversely, when during a downswing external financing contracts and the cost of borrowing rises, private sector credits also contract and non-interest fiscal spending may need to be severely retrenched – all of which exacerbates the recessionary trend in the economy. This reduced capacity to implement countercyclical policies implies that access to international financial flows also affects the real economy, although not by smoothing the business cycle, as anticipated by economic theory, but by magnifying it: inflows often lead to output expansion and outflows to contraction and stagnation (Prasad et al (2003); Kaminsky et al (2004); Stiglitz et al (2006)).

Financial volatility, rather than lack of price and wage flexibility (as emphasised in the past by the “neo-classical synthesis” and more recently by orthodox economists), is the major source of real macroeconomic volatility in developing countries (Easterly et al (2001)). Inadequate regulatory and legal frameworks and weak financial systems in developing countries increase the propensity for these systems to be unstable, as these conditions lead investors to engage in excessively risky lending (WB (1999); FitzGerald (2006)). Surges in external financing at initially low cost exacerbate the tendency for countries to take excessive risks and create the conditions for domestic financial systems to be volatile.

In developing countries, the governments’ room for manoeuvring in macroeconomic policymaking is limited to counteracting these developments with traditional instruments. Fiscal policy can always play a role but is likely to be a relatively ineffective instrument as the budget process tends to be inflexible relative to the volatility of capital flows. Moreover, using fiscal policy to counter volatility in financial markets conflicts with other developmental goals, such as the need to make sustained long-term investments in human resources and physical infrastructure (see below). Tighter monetary policy and sterilisation during financing booms can even lead to further increases in capital inflows with open capital markets. Particularly, it may attract volatile short-term flows to higher real interest rates. In turn, because of the lack

of space for effective countercyclical macroeconomic policies, the failure to contain the impact of surges in capital inflows means that a sudden stop of access to external financing will create large macroeconomic imbalances and sizeable downward adjustments of the economy. Under these conditions, contractionary monetary policies then just help transform the reduced availability of external financing into a domestic recession.

Exchange rate policies face additional tradeoffs. As previously noted, an exchange rate peg reduces the capacity of monetary policy to act as a countercyclical tool. Although a flexible monetary policy creates more space to undertake countercyclical monetary policies, it does so only at the cost of exacerbating cyclical swings in the exchange rate. Aside from the effects of real exchange rate volatility on growth, such swings have *procyclical* wealth (balance sheet) effects in economies where agents have net liabilities denominated in foreign currencies. Under such conditions, which are quite typical in developing countries, exchange rate appreciation during booms generates positive wealth effects, whereas devaluation during crises creates negative wealth effects. The additional degrees of freedom to undertake countercyclical monetary policies and the countercyclical effects that exchange rate fluctuations have on the current account may be entirely washed away by the procyclical wealth effects of currency adjustments (ie their effects through the capital account). Furthermore, although exchange rate fluctuations may reduce some sources of volatility, such as currency mismatches in portfolios, these fluctuations may generate other sources of volatility, such as short-term speculative moves.

All in all, neither a fixed nor a flexible exchange rate regime provides sufficient room for manoeuvre for countercyclical macroeconomic policies. Other policy instruments are needed, as discussed at the end of this paper.

The volatility and procyclical nature of private capital flows to developing countries also explain in part why no evidence can be found that such capital movements in general have resulted in increased investment or higher long-term economic growth during the past three decades (Ramey and Ramey (1995); Prasad et al (2003); Kose et al (2005)). Financial volatility has translated into increased investment uncertainty and greater output volatility, which, as discussed earlier, have been detrimental to long-term economic growth. Moreover, while capital surges stimulated aggregate demand and output, such welfare gains were often more than fully reversed in situations when the sudden stop triggered a financial crisis.⁴

3.2 The role of financial liberalisation and financial market development

The impact of unstable capital flows on the business cycle cannot be separated from the process of financial liberalisation and the degree of financial market development in developing countries.

Financial liberalisation, at both the national and international level, has contributed to higher volatility and more procyclicality. Market agents tend to underestimate risk during booms, making loans to borrowers with lower credit quality. The rapid increase of asset prices during booms further stimulates credit growth. The tendency for provisions to be related to the

⁴ Capital flow volatility has been an important cause of the financial crises that have occurred with increased frequency in developing countries since the 1980s. As crises have resulted in slow growth for a number of years after an initial large decline in output, they have reduced output levels below what they would have been otherwise. Some estimates put the cumulative loss of output at as much as 25% in the last 25 years (Eichengreen (2004)). Griffith-Jones and Gottschalk (2006) estimate the average annual costs incurred by the four hardest-hit Asian crisis countries (Indonesia, Korea, Malaysia, and Thailand) at around US\$ 150 billion during 1997–2002, or about 72% of their combined GDPs. Another study found an average cost of lost output (relative to trend output) of 18.8 percentage points of GDP per crisis during 26 banking and currency crisis episodes in emerging market economies in Latin America and Asia during the 1980s and 1990s (IMF (1998): Table 15). Losses in output growth occurred in three quarters of the cases.

current rate of loan delinquency (or the expected rate in the immediate future) further increases this procyclical bias. During booms, delinquencies are few and provisioning for loan losses is limited, all of which reduces the apparent costs of lending and thus increases credit growth. On the contrary, during downturns, delinquencies increase, provisioning has to increase and lending is curtailed and may even lead to a “credit squeeze” that amplifies the economic downswing. Concern about weaknesses in the financial system during a downturn may prompt the introduction of stronger regulatory requirements, further aggravating the problem of credit availability in the short term (Ocampo (2003)).

In this respect, the existence of an adequate regulatory framework is critical to mitigate the problems generated by excessive risk taking, but is not the only aspect that matters for financial stability. Insufficiently developed financial markets may also cause problems of financial instability in the face of capital flow volatility and further limit the effectiveness of fiscal and monetary policies. Important features of insufficiently developed financial markets in many developing countries are the shortage of an adequate supply of long-term bank lending and the absence of a domestic market for long-term government and corporate bonds denominated in the domestic currency. In a context of financial liberalisation, these deficiencies may create problems in investment as well as in financial stability. The lack of long-term financing makes it more difficult to fund public infrastructure investment and major private modernisation projects. It also forces firms seeking to finance long-term investments either to use short-term debt, thus accumulating maturity mismatches in their balance sheets, or to borrow more in international markets, leading to currency mismatches. Developing countries are thus characterised by private and public sector portfolios that hold variable mixes of maturity and currency mismatches. Such mismatches increase financial fragility in periods of exchange rate depreciation and rising interest rates, which usually coincide due to the procyclical availability of external financing. The insufficient development of domestic bond markets and the associated financial fragility in turn reduce the scope for monetary intervention to counteract external shocks.

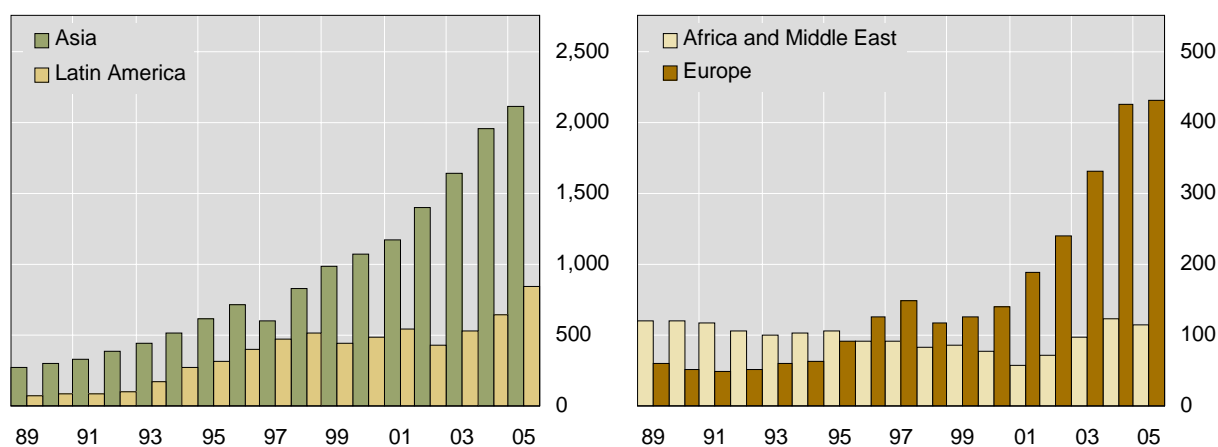
The Asian crisis made clear the importance of domestic bond markets, which led to a stronger focus of financial policies on their development. As a result, domestic bond markets have grown rapidly since the late 1990s, not only in Asia, Latin America and the emerging countries of Europe, but also, to a lesser extent, in Africa (see Figure 3).⁵ Although this is certainly a positive development, the lack of an adequate demand for long-term bonds in these markets implies that, in most cases, the reduction in currency risks has occurred at the cost of rising maturity risks. Also, in the presence of liberalised capital flows, these markets may be the subject of intense speculation when expectations regarding exchange rates are volatile. This was clearly manifested, for instance, during the period of turbulence that characterised world financial markets in May–June 2006.

⁵ The growth of the domestic bond market is also substantial when expressed as a percentage of GDP, increasing by 13–16 percentage points in Asia, Europe and Latin America. Only for Africa is there a decline, when expressed in these terms, by 0.5 percentage points.

Figure 3

Domestic bond market growth in developing countries

Amounts outstanding, in billions of US dollars



Asia includes China, Hong Kong SAR, India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, South Korea, Taiwan, Thailand; Africa and Middle East includes Lebanon and South Africa; Europe includes Croatia, Czech Republic, Hungary, Poland, Russia, Slovakia and Turkey; Latin America includes Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Source: Ocampo and Griffith-Jones (2006).

Domestic financial liberalisation is frequently associated with integration into the global capital market – that is, with external financial liberalisation. In principle, this should make an international pool of liquidity available to the domestic financial system, which should then become more stable. However, as indicated above, the high degree of volatility of international capital inflows combined with the maturity and currency mismatches in the portfolios of economic agents makes the recipient countries subject to shocks and crises, which can be large and frequent.

These factors confirm the position taken in the Introduction of this paper, namely, that merely focusing macroeconomic policies on low inflation and restoring the fiscal balance may be too narrow of an approach to achieve desired growth gains, especially if the emphasis on monetary restrictions and fiscal prudence depresses economic activity in the short run and restricts broader developmental policies. Also, in a context of open and liberalised financial markets, the role of policies in promoting a growth-oriented environment for the private sector depends not only on macroeconomic and development policies, but also on the structure and level of development of the financial sector. The potential contribution of financial development to economic growth is considerable and financial liberalisation can help establish more efficient and liquid financial intermediation. However, as this section underscores, these contributions to growth cannot be taken for granted, and the growth impact depends on the construction of the appropriate institutional structure. Financial structures are very different across the world, and there is no unique relationship between financial structure and levels of or growth in income per capita. What matters is that the financial sector ensure adequate finance for productive investment of enterprises, including small and micro-enterprises and farms, and for long-term investment. Depending on the stage of development, doing so may imply ensuring a domestic bond market for long-term financing in the domestic currency and reserving an important role for public sector banks (particularly development banks). Institutional development should also guarantee adequate regulation and supervision to guarantee sound financial sector balance sheets.

3.3 Fiscal and monetary policy rules versus discretionary flexibility

Deficiencies in the domestic institutional framework typically provide other sources of procyclical macroeconomic policy stances and limits to the effectiveness of macroeconomic policies. One source, mentioned above, relates to fragile and poorly regulated banking and financial systems. Others relate to the framework for fiscal policy. In some cases, the origin may lie in volatile government revenues associated with heavy dependence on primary commodities and the related price fluctuations in global markets. When prices are high and the economy is booming as a result, governments tend to engage in expansionary spending behaviour. When prices collapse, government revenue falls, and fiscal austerity may be necessary at a time when the economy is entering a recession. Instruments such as stabilisation funds can be beneficial for commodity-exporting developing countries. Some countries have managed commodity stabilisation funds to smooth the impact of volatile commodity prices on fiscal income. Such funds have included Chile's Copper Compensation Fund, Colombia's National Coffee Fund and Burkina Faso's Cotton Support Fund. However, their performance has been variable, and hence also their role in mitigating the procyclical nature fiscal policy. The institutional capacity to manage these funds adequately is an important factor in their performance (Gottschalk (2005)).

Some developing countries, such as Chile during the current decade, have been able to manage fiscal targets that are independent of short-term fluctuations in economic growth (so-called structural budget rules). The management of this countercyclical policy stance has been one ingredient in Chile's much stronger growth performance and macroeconomic stability than that of other Latin American countries (Fiess (2002); Ffrench-Davis (2006)). Effectively managing such a system requires prudent and consistent policymakers and political support to uphold the rules.

More generally, since the 1980s there has been a shift from discretionary-based macroeconomic policy arrangements to rule-based ones, a shift based on the belief that the establishment of rules can avoid policy-generated macroeconomic instability. But an entirely rule-based system is not the answer, either. For instance, inflation targeting has been adopted in about 20 economies, including a fair number of developing countries. Under this monetary regime, an independent central bank commits itself to price stability by making public a pre-fixed inflation target range. There are a number of merits associated with such a policy arrangement, including its potential to enhance the central bank's policy transparency and credibility (UN (2000)). However, its narrow focus on the inflation target may generate a bias towards maintaining a strong exchange rate, make macroeconomic adjustment procyclical in response to external shocks (including shocks that affect the availability of external financing) and, more generally, bias macroeconomic stabilisation against employment and growth objectives.

Rule-based policies generally function well under normal circumstances but, as the economic structure changes over time and different shocks occur (both demand and supply shocks), the predetermined policy rules can become less relevant or too rigid. Moreover, because the risks and uncertainties that an economy faces may be non-stationary – that is, transitory shocks may permanently displace the trajectory of major macroeconomic variables – a certain degree of discretion in policymaking is always needed during abnormal periods, such as in crises, so as to minimise the risks for huge macroeconomic losses. The successful experience of East Asian economies and a few other developing countries has shown the merits of balancing rules and flexibility (UN (2006)).

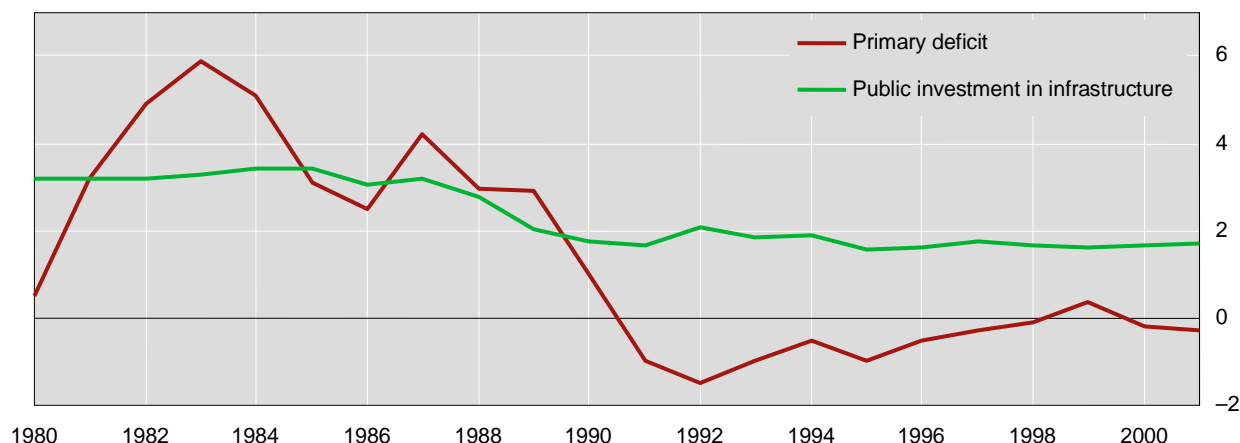
Procyclical macroeconomic policies probably also affect long-term investments in development, especially infrastructure and human capital development. The argument we develop here relates specifically to infrastructure investment, but similar arguments apply to expenditures in human development (see UN (2006)).

The countries of Latin America and sub-Saharan Africa have exhibited procyclical fiscal behaviour and have failed to sustain adequate levels of investment in physical infrastructure. The precise causality may have to be established on a country-by-country basis, but it is noteworthy that the East Asian countries that maintained more neutral or countercyclical policy stances did maintain relatively high levels of infrastructural investment. While in Africa

aid seems to have helped to sustain capital expenditures (though not maintenance expenditures), Latin American countries witnessed a decline in infrastructural investment over time as a result of increased fiscal austerity since the 1980s. Public spending on infrastructural investment declined from 3% of GDP in 1980 to less than 1% in 2001 for a group of seven Latin American countries (see Figure 4 and WB and IMF (2006)).

Figure 4

Latin American primary deficit and public infrastructure investment¹



¹ GDP weighted regional average of public investment and primary fiscal deficit based on data for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Sources: World Bank; IMF (2006).

Much of the decline in public spending can be traced to fiscal adjustment as implemented in stabilisation programmes, which were, as indicated, largely procyclical. Such spending cuts may reflect policymakers' preferences over reductions in current expenditure, which would be more difficult to sustain politically in the short term. Yet these cuts compromise long-term fiscal sustainability as the potential for additional fiscal revenues – at given levels of taxation – is reduced by lower growth in the future. Moreover, there are non-linear scale effects of infrastructure on growth; the incapacity to maintain infrastructure above certain minimally necessary thresholds may halt the growth process altogether. Analysts have estimated, for example, that the reduced infrastructure asset accumulation resulting from lower public investment lowered GDP growth by more than one percentage point in several Latin American countries during the 1980s and 1990s (Calderón et al (2003); Rodríguez (2006)). As a result, much of the anticipated favourable effect of infrastructure spending reduction on the fiscal position was offset by higher deficits resulting from lowered output growth in the years following the adjustment. Apart from cases of politically motivated and inefficient or unnecessary investment, lower public spending on infrastructure will eventually weaken rather than strengthen fiscal solvency, which is contradictory to the initial intention of fiscal adjustment.

In sum, procyclical macroeconomic policies may be intrinsic to a country's institutional framework, and are enhanced, in particular, by excessive reliance on external sources of finance and unstable tax bases. It is therefore important to find institutional ways to create more space for countercyclical macroeconomic policies.

4. Policy implications

4.1 A broad framework for macroeconomic stability

Macroeconomic stability strongly influences the long-term growth performance of an economy. However, it should be seen as more than just preserving price stability and sustainable fiscal balances. Macroeconomic stability is also about avoiding large swings in economic activity and employment and, further, about maintaining sustainable external accounts and avoiding exchange rate overvaluation. The frequency of financial crises in developing countries indicates that macroeconomic stability is also about maintaining well regulated domestic financial sectors, sound balance sheets of the banking system and sound external debt structures.

Strong and sustainable growth makes it easier to achieve greater macroeconomic stability by enhancing, among other things, the sustainability of domestic and foreign public debt. Conversely, greater stability, in its broad sense, reduces investment uncertainty and hence is supportive of higher long-term growth.

For many governments of developing countries, the space for conducting countercyclical macroeconomic policies is limited, as the available fiscal and foreign exchange resources tend to be small relative to the size of the external shocks they face. International action mitigating the impact of private capital flow volatility (see below) can enhance the necessary policy space. Nevertheless, governments of developing countries can take measures at the national level to enhance the scope for countercyclical policies by improving their institutional framework for macroeconomic policymaking.

4.2 Macroeconomic policies and national development strategies

The more appropriate institutional setting for fiscal policy should strike, first of all, a balance between fiscal prudence and flexibility in a way that ensures both policy credibility and fiscal sustainability. Setting fiscal targets that are independent of the short-term fluctuations in economic growth (so called structural budget rules) can be an effective means to force a countercyclical policy stance. Fiscal stabilisation funds can also help smooth over time the revenues from unstable tax sources, such as those based on primary export production. Although the experience with the application of such funds in various parts of the world has varied, they can become an effective instrument for resolving inter-temporal tradeoffs in fiscal spending by protecting growth-enhancing, long-term public investment in infrastructure and human development, even during times of lower tax revenue caused by external shocks and economic downturns.

Second, policies should leave room for governments to retain a certain degree of discretionary power. Rule-based policies may be too rigid to respond to macroeconomic volatility. Furthermore, some rule-based regimes, such as inflation targeting, may bias macroeconomic stabilisation toward a narrowly defined target (low inflation) and against broader employment, growth and other developmental objectives.

Third, macroeconomic policies should be well integrated with other areas of economic (and social) policymaking. In the fast-growing East Asian economies, for example, macroeconomic policies were part of a broader development strategy, contributing directly to long-term growth. Fiscal policies in these economies have prioritised development spending, including investment in education, health and infrastructure as well as subsidies and credit guarantees for export industries. Monetary policy was coordinated with financial sector and industrial policies, including directed and subsidised credit schemes and managed interest rates to directly influence investment and saving, whereas competitive exchange rates were considered essential to encouraging exports and export diversification. In contrast, macroeconomic policies in many Latin American and African countries since the 1980s have

been focused on much more narrowly defined short-term stabilisation objectives and have resulted many times in exchange rate overvaluation.

Finally, in today's open economies, a competitive real exchange rate seems to be critical for achieving such crucial development objectives as the diversification of production and export structures, which is critical to growth, and employment generation. Active exchange rate strategies are needed to achieve this task, as are complementary policies that may improve real exchange rate competitiveness. The association between real exchange rate stability and growth implies, therefore, that some degree of real exchange rate targeting should be a main objective of central bank policies.

4.3 Capital account and financial market policies

Managing countercyclical macroeconomic policies in the face of volatile capital flows may require the use of additional policy instruments. Given that the major source of disturbances is associated with the integration of developing countries into global financial markets, managing such integration makes sense (Ocampo (2003); Stiglitz et al (2006)).

The mix of maturity and currency mismatches that characterise the balance sheets of financial and non-financial firms in developing countries is a major determinant of the vulnerability of developing countries to financial market volatility. This is why creating long-term domestic markets for assets denominated in the domestic currency and developing well functioning derivative markets as protection against exchange rate and interest rate fluctuations should be at the centre of financial policies.

In the face of significant levels of segmentation in international capital markets, deliberate segmentation of domestic and financial markets also makes sense, as it helps to protect the domestic economy from the volatility produced by capital market liberalisation. Since the local currency and the local currency assets of most developing countries do not have a stable foreign demand, their domestic capital markets are already segmented from international markets. In turn, the highly procyclical pattern of provisioning of finance to developing countries reflects the segmentation of international capital markets according to the perceived level of risks of different assets and debtors, and the associated alternation of periods of "risk appetite" and "flight to quality". Well designed quantity- or price-based capital account regulations can be used to segment the markets more effectively. Such regulations may be understood as a "second-best" intervention that is already in place. While quantity-based regulations can be more effective in the short term, price-based regulations are more market-friendly (Ocampo (2003)). Nevertheless, it certainly does not make sense to design regulations as if segmentation did not exist.

Managed segmentation also enhances the ability of government to control the macroeconomy. The ability of policymakers to use restrictive monetary policies during times of euphoria and to avoid excessively contractionary policies during crises (in other words, the level of a government's monetary autonomy) is enhanced by constraints on capital mobility, which, in turn, depend on the degree of market segmentation. Similar arguments apply to the exchange rate. Segmentation increases a government's ability to use the exchange rate as a macroeconomic policy tool and improves the effectiveness of exchange rate management. It can help avoid overvaluation and smooth the procyclical wealth effects that characterise economies with large debts denominated in foreign currencies.

Governments can use "soft controls" to segment the market directly. Soft controls can, for example, require domestic funds, such as social security or pension funds, to invest their assets in domestic rather than foreign markets or to limit the amount of funds in foreign markets. These restrictions reduce the likelihood of procyclical disturbances generated by these funds. Soft controls have additional positive effects on the economy: they create a local demand for domestic securities, help to develop the local capital markets and build a

domestic capital base. In these ways, soft controls can help remedy one of the market failures discussed earlier: that of under- and undeveloped capital markets.

In addition to direct regulations, governments can use a variety of indirect measures to control (or at least influence) capital account inflows and outflows. The most critical use of regulations is to avoid currency mismatches in the balance sheets of financial and non-financial agents. Prudential regulations on the banking system are one such tool. Numerous countries forbid, or strictly limit, banks from holding currency mismatches on their balance sheets. To avoid domestic financial dollar-/euroisation, many countries also prevent financial institutions from allowing domestic residents to hold deposits in foreign currencies, or limit the nature and use of such deposits. Bank regulators can also prohibit domestic banks from lending in foreign currencies to firms that do not have matching revenues in those currencies. More subtly, they can impose higher risk-adjusted capital adequacy requirements or additional liquidity and/or loan-loss provisioning (reserve) requirements on foreign currency loans made to domestic agents who lack matching revenues.

Regulations can also directly target borrowing abroad by non-financial firms. Such regulations might include rules on the types of firms that can borrow abroad (eg only firms with revenues in foreign currencies) and set prudential ratios for such firms. Regulations might also include restrictions on the terms of corporate debt that can be contracted abroad (eg minimum maturities and maximum spreads) and public disclosure of the short-term external liabilities of firms.

These alternative measures rely on a combination of banking regulations and complementary policies aimed at non-financial firms, but the direct capital account regulations discussed earlier may be simpler to administer. Such controls may work better because they are aimed at the actual source of the disturbance, ie procyclical capital flows. Developing countries with strong administrative capabilities may be able to handle a combination of direct and indirect measures in order to reduce capital flow volatility and limit circumvention by investors of those measures through the use of derivative products.

Finally, to reduce the procyclicality brought by the financial sector volatility, one possible policy measure is to require forward-looking provisioning that is estimated on the basis of expected or latent losses (rather than on prevailing losses) when loans are disbursed, taking the full business cycle into account (Ocampo (2003)). Such a step would help smooth the cycle by increasing provisions or reserves during boom periods and thereby help to reduce the credit crunch during downturns. Along with this measure, regulators should encourage the adoption of risk management practices and models that would allow lending strategies that are less sensitive to short-term factors (see eg Griffith-Jones et al (2003)).

4.4 International policies to reduce financial volatility

A major challenge for multilateral financial institutions is to help developing countries mitigate the damaging effects of volatile capital flows and provide countercyclical financing mechanisms to compensate for the inherently procyclical movement of private capital flows. A number of options are available to dampen procyclicality and thereby help create a better environment for sustainable growth (Ocampo and Griffith-Jones (2007)).

A first set of measures would be for the multilateral development banks and export credit agencies to adopt financial instruments that reduce currency mismatches and link debt service obligations to the capacity of developing countries to pay (eg through GDP- or commodity-linked bonds). In addition, these institutions could issue public loan guarantees with countercyclical features.

Multilateral surveillance, primarily by the IMF, should remain at the centre of crisis prevention efforts. Enhanced provision of IMF emergency financing in response to external shocks is essential for lowering the unnecessary burdens of adjustment and the costs of large reserve balances. For both middle- and low-income countries, the appropriate facilities should

include liquidity provision to cover fluctuations in export earnings, particularly those caused by unstable commodity prices and natural disasters. Access to official international liquidity during capital account crises should be facilitated and made commensurate with the potentially large needs of countries, which may surpass normal lending limits based on IMF quotas.

Despite recent progress in advancing a market-based approach to the orderly and cost-effective resolution of debt crises (eg the adoption of collective action clauses in sovereign bond contracts and the “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets”), there is no consensus on the role to be played by multilateral institutions. The review of the effectiveness of the IMF instruments in facilitating crisis resolution, including “lending into arrears” policy and information dissemination, should help clarify the role the IMF could play in crisis situations, thus providing an additional means for helping countries get back on the road to sustainable economic growth.

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