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**The crisis of orthodox macroeconomic
policy : The case for a renewed
commitment to full employment**

Muhammed Muqtada

Employment
Sector

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*¹ which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work², in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.³

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.⁴

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

José Manuel Salazar-Xirinachs
Executive Director
Employment Sector

¹ See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

² See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

³ See <http://www.ilo.org/gea>. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work*, "Vision" document, ILO, 2006.

⁴ See <http://www.ilo.org/employment>.

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Foreword

With the onset of disruptive (oil) supply shocks in the 1970s, followed by the election of conservative, « neo-liberal » administrations in the United Kingdom and the United States in 1979 and 1980, respectively, a new macroeconomic orthodoxy emerged, one that tended toward a retreat of the State in both economic and social spheres. The new economic doctrine, ultimately codified as the Washington Consensus by John Williamson in 1989, emphasized macroeconomic stabilization, the path to which most often involved the reduction of fiscal deficits, in part through privatization, “getting prices right” by controlling inflation through strict monetary policy, and market liberalization predicated on the assumption that “free markets” unfettered by State intervention were the most efficient means of resource allocation and consequently economic growth. The doctrine soon spread throughout the developing world, in part, as a conditionality imposed by international financial institutions, and to this day remains lodged in many developing countries’ macroeconomic policies.

Results nonetheless disappointed. There proved inter alia to be little correlation between growth and the chief macroeconomic variables believed, under the new orthodoxy, to affect it. Indeed, the most convincing engine of growth was (and remains) the share of investment in GDP. More disappointing still was employment performance, treated as a “residual” of getting macroeconomic fundamentals right.

This paper, by one of the ILO’s most senior economists, is an objective and empirically anchored “short history” of the evolution of macroeconomic thinking over the past quarter century from its neo-liberal origins to the present day’s search for a more employment-centred macroeconomic framework. The author marshals to great effect both theory and evidence in advancing his argument. And his is a balanced argument, mindful of the historical context in which theories and the policies they engender emerge. Thus, for example, the author fully acknowledges that the focus on greater macroeconomic discipline inherent in the Washington Consensus was indeed often warranted and needed. It was, in short, necessary in many countries; in just as many if not more, however, it was insufficient – delivering one-off, static efficiency gains, while constraining dynamic efficiency.

As we in the ILO endeavour to think through how to make employment a more central objective of macroeconomic policy, the sound guidance in Dr. Muqtada’s paper provides a solid foundation.

Duncan Campbell
Director for Policy Planning
Employment Sector

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1. Introduction

The World Summit for Social Development held in Copenhagen in 1995, essentially to review social attainments and progress of the last quarter of the 20th century provided, arguably, a significant impetus to the debates on macroeconomic policymaking. During nearly two decades prior to the year of the Summit, most developing countries were largely locked in a one-size-fits-all macroeconomic policy framework that was singularly focused on achieving macroeconomic stability. The now well-documented unsatisfactory economic outcomes and the social costs of the policy reforms that were largely induced by the conditionality of the stabilization-centred lending programmes of the Bretton Woods institutions underlined the universal disenchantment at the Summit. The Copenhagen Declaration that came out of the deliberation of the Summit carried a commitment, of more than eighty participating Heads of State and government, to “promoting the goal of full employment as a basic priority of our economic and social policies”¹. Such a commitment on full employment was not only an expression of solidarity with all those in poverty and poor working conditions, but also a collective resolve to pursue a development agenda that ensured both economic and social progress. The neo-liberal, orthodox macroeconomic policies that upheld that markets (including that of labour) would clear if prices were “right” came under intense scrutiny. Thus, the Summit, by drawing attention to the dismal social progress during the 1980s and 1990s, and by endorsing a commitment to full employment as a way forward, challenged the reigning macroeconomic strategy of the day.

The full employment objective that was central to macroeconomic policies of the so-called “golden era” of growth during the 1950s and 1960s disappeared from the macro-economic agenda during the era of stabilization that followed. Its significance came to be relegated in the aftermath of the oil-price shocks of 1973 and 1979, which triggered a global recession, including a severe debt and foreign-exchange crisis in many Latin American countries. Owing to dwindling resource flows, rising interest rates in international borrowing, and rising debt/GDP ratios, the bulk of the developing countries were caught in a web of macroeconomic imbalances. The Bretton Woods institutions, to which these countries turned to for resources, offered loans that were conditional on (what later came to be known as) “inflation targeting” and on belt-tightening in the fiscal and current accounts. The Washington Consensus, now well-known even to non-practitioners, provided the blueprint of a new development alternative where employment and social progress were predicated on sound macroeconomic fundamentals and allocative efficiency of the market. This called for a major shake-up in the design of macroeconomic policies that in turn warranted pervasive liberalization in both the tradable and non-tradable sectors. Liberalization, which in the 1970s was advanced by the IFIs as an advocacy, soon became conditionality.

Since the early 1980s, this “macroeconomic prudence” almost decisively altered the course of employment-centred macroeconomic policies of the previous era, both in developed and developing countries. In the latter countries, during the next two decades, stabilization (and the closely associated structural adjustment programmes to support de-control and liberalization) was held as the central tenet in their economic policy designs.

¹ See the text of Commitment 3 of the Copenhagen Declaration and Programme of Action of the World Summit for Social Development, 1995.

As we noted, this neo-liberal *mantra* was maligned at the Copenhagen Summit, 1995. Moreover, this conservative reforms package was pursued not only during the normal times, but also in recessionary periods. Such prescriptions were challenged by the countries hit by the Asian crisis during 1997-98 when pro-cyclical policies only helped to aggravate a regional recession. Yet, the *mantra*, in various modifications, appears to hold sway in the developing countries even today, both in normal periods as well as during crises (as the most recent post-crisis 2008-09 IMF stand-by loan agreements with several countries, affected by the 2008-09 crisis, would testify).²

This chapter critically reviews the macroeconomic experiences of the past three decades to argue the case against orthodox macroeconomics. It then proceeds to suggest that the prevailing orthodoxy in macroeconomics needs to give way to an alternative policy paradigm in which the Copenhagen commitment on full employment, subsequently incorporated as a Millennium Development Goal (i.e. added to MDG1 in 2008), plays a central role. The global recession of 2008-2009 reinforces the potency of this proposition.

2. A brief empirical account

It may be useful to recall the three major “facts and controversies of the 1990s”, as recounted in World Bank (2005): (i) stabilization measures, combined with liberalization were central to the reforms programme, (ii) “conventional wisdom held that to achieve greater efficiency required a reduction in the role of the state; and (iii) “reforms had to be rapid”.³

The policy reforms to getting prices “right” brought in their sweep quite draconian measures fairly rapidly. Thus, during the 1980s and 1990s, most of the developing countries adopted, with a degree of urgency, a series of inter-related policy measures to usher in rapid economic liberalization, trade in particular. In addition, several “structural adjustment programmes” were also introduced, essentially intended to reign in the role of the state, and public interventions (e.g. privatization; de-control etc) and to facilitate market efficiency, including through labour market flexibility, to encourage private sector participation. As we now know, the above measures which were central to the World Bank /IMFs lending programme, generated huge debates as the outcomes of the measures that were implemented came under scrutiny by the academia as well as the policy planners.⁴ These policy reforms and programme measures, which gradually found articulation in a stabilization-focused framework of macroeconomic strategy, had a passionate following among the neo-liberal academia. At the same time criticisms and contentions to this approach began to mount as the one-size-fits-all strategy failed to produce tangible signs of sustained growth. Reviewing this extensive literature would be a task on its own. For the empirical record, Easterly (2002) provides a thorough and systematic account of the impact of the policy reforms on growth during the 1970s till

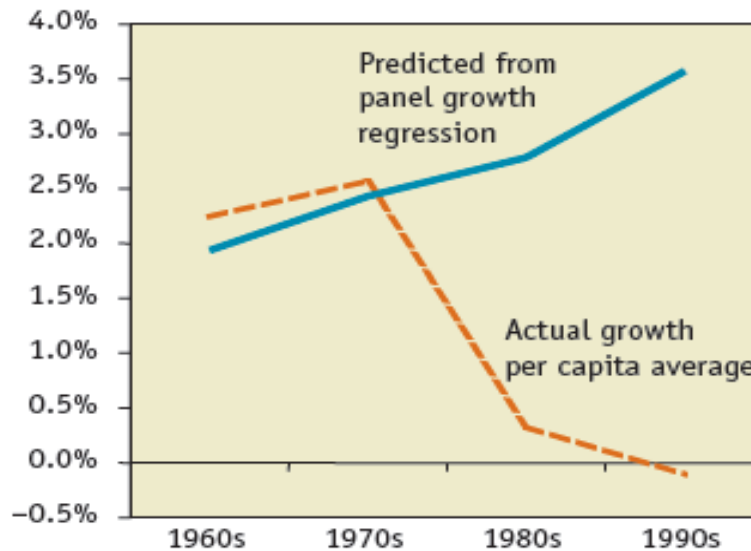
² See Hailu (2009)

³ For an account of the principles behind these reforms, see World Development Report, 1991; also Williamson (1997)

⁴ For a defence, see Krueger (1992); Fischer (1993); Bredenkamp & Schedler, eds (1999); critiques from various standpoints include Banuri (1990); Muqtada (2003); Islam, I (2003) Mckinley (2001); Stiglitz (1998); Taylor (1998), among others.

the 1990s. The author clearly establishes that actual growth declined; and fell far below what was predicted. He has dubbed the period as “lost decades”.

Figure 1: Divergence of actual and predicted growth over the 1970s-1990s



Source: Easterly 2002.

The present author assesses further evidence on the relationships observed between the stability variables and GDP growth⁵ based on panel data for 80 developing countries.⁶ The main findings are as follows:

- nearly two decades of stabilization reforms have in fact reduced the inflation levels in most countries of the world;
- with the exception of a few countries, growth of GDP is observed to be low or inadequate during the 1980s and much of the 1990s;
- despite substantial declines in inflation rate and budget deficit, hence arguably better macroeconomic stability, investment-to-GDP ratio (I/GDP) has failed to gain momentum;
- I/GDP as a single variable tends to explain growth better than “stability” variables; and
- Current account deficit is negatively related to growth but not robustly⁷.

⁵ See Muqtada (2003);(2009)

⁶ Data taken from WDI data base of the World Bank, 2009.

Table 1: GDP growth and stabilization: 1980-2007

Dependent variable: GDP growth (%)				
Investment (GFCF)	0.213*** (0.0277244)			
Budget deficit		0.135* (0.0685389)		
Inflation			-0.003** (0.001)	
Current Account Balance				-0.052 (0.042)
Constant	-0.835 (0.604)	3.769*** (0.226)	3.755*** (0.251)	3.407*** (0.297)
R ²	0.425	0.056	0.067	0.019
Adj.R ²	0.418	0.041	0.054	0.007
N° of countries	82	68	82	82

Source: Author's calculations based on World Bank, WDI 2009 online.

Notes: OLS regression is applied to obtain the above results. Standard errors in parentheses, *** 1%, ** 5%, * 10% level of significance.

Table 1 brings out the limited explanatory power of the individual stability indicators. It further confirms the significant role of I/GDP in explaining growth, which opens up a host of issues with respect to what, in fact, explains the growth in investment, and why despite all efforts at stabilization, investment failed to pick up. As the experiences of the East Asian growth success have shown us, macroeconomic stability was only one of the objectives of their macro-policy; financial policies and incentives towards resource mobilization as well as focused public interventions helped boost saving and investment in these economies.

As noted above, the defence of, and disenchantment with, the stabilization-focused policy reforms produced debates on the appropriate design of macroeconomic strategy. Often, however, the debates were diverted, away from the core objectives of macroeconomic policy, to why stabilization pursuits at the country-level were not yielding expected output outcomes. Attention was thus deflected toward the pace and sequence of stabilization; to rigid labour markets; and, not least, to the lack of good governance. Nonetheless, the long record of low and inadequate growth, and widespread unemployment and poverty, certainly called for a serious review by the authors of these policy reforms.

3. Macroeconomics of stabilization: Static gains vs. dynamic efficiency

While there was a growing body of literature that was critical of the policy reforms, an honest self-evaluation from the reforms-enforcing agencies was long in coming. World Bank (2005) produced, arguably, the most intensive self-evaluation. It observes: "In retrospect, it is clear that in the 1990s we often mistook efficiency gains for growth.

⁷ This draws on Muqtada (2009); there is a lot of scepticism expressed with regard to the econometrics, as well as the policy conclusions in respect of such "growth equations". cf. Bazza and Clemens (2009)

The “one size fits all” policy reform approach to economic growth and the belief in “best practices” exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both theoretically incomplete and contradicted by the evidence.”

The stabilization and structural adjustment policies were indeed directed toward achieving an enabling macroeconomic environment that would likely encourage both domestic and foreign investment, and facilitate long-term capital accumulation and growth. If nearly two decades of such policy reforms have not yielded a return to growth, what precisely have these reforms achieved?⁸ As noted, the recent evaluation by the World Bank itself seems to suggest that macroeconomic stabilization policies have often led to static gains, and that not enough attention has been given on how dynamic efficiency would be further reaped⁹. In plain economic terms, this would simply reiterate what critics of the Washington Consensus have maintained, i.e. in most countries a degree of stability has been achieved, but that this has not necessarily led to growth and investment.

One clear, and possibly the most significant, indicator of such stability is the price discipline. There is no doubt that a fairly substantial reduction in the inflation levels has been attained in the developing countries, especially when one compares the 1980s and 1990s with the 2000s (see Appendix Figure A1). Whereas, during 1980-89, only nine countries registered an inflation level of below 5 per cent, during 2000-06, nearly 34 countries achieved this target. If the inflation level were to be extended to 10 per cent, then as many as 65 developing countries would belong to this category. Indeed, policies toward “getting prices right”, chiefly through strict monetary policies and fiscal discipline, have brought about this so-called “static” gain. Apart from such downward trends in inflation, similar empirical evidence is also available to show fairly tangible declines in budget deficits, and current account deficits - the other two variables that have been the usual targets of stabilization policies.¹⁰

Should then the debate surrounding the role and outcome of the orthodox macroeconomic policy framework end on the note indicated by the World Bank evaluation ; that is, some static gains have been achieved, but these have not necessarily led to the expected returns to investment and growth ? There have been a few exceptions. Chile, for example, which during the 1980s and 1990s pursued macroeconomic reforms, attained fair degree of stability and growth. One must note, however, that the country incorporated additional policies and incentives to encourage savings and investment, boost productivity and exports. Chile was not averse to accepting external capital but introduced capital controls to discourage short-term capital inflows.¹¹

⁸ C.f. Easterly (2002).

⁹ World Bank (2005); op.cit

¹⁰ See, World Bank (2005); Muqtada (2003);

¹¹ During the era of globalization, developing countries were often strongly urged by IMF and other stakeholders to liberalize their financial sector, and capital account . The Asian financial crisis 1997-98, and the recent recession of 2008-09, exposed the grave risks of such liberalization, unless appropriate domestic regulations, and capital controls (esp. on short-term debts) were not put in place. Ostry et al. (2010) contends that capital controls are necessary in order to shield developing countries from external shocks and financial instability. Malaysia and Chile during the 1980s and China and India in the subsequent period adopted, to their advantage, a cautious approach to capital account liberalization.

Chile's experience during the stabilization reforms era has been more of an exception to the norm, ie in terms of growth, though not necessarily in terms of quantity and quality of job creation¹² In most of the developing countries, a persistence of the pursuit of stability without acceleration in growth actually implied difficulties in sustaining such stability. While it was amply clear that higher level of growth and employment generation would require substantially increased resources and expenditure (e.g. on physical and social infrastructure), the stabilization measures continued to squeeze the fiscal space for undertaking such expenditures.

Apart from the World Bank's self-evaluation, a key (re)-interpretation of the Washington Consensus is laid out in Besley (2005), which contains a series of essays by policymakers on the interface between policy experiences and analytical discourse¹³. The debate that initially surrounded the stricter orthodox macro policies that accompanied the early years of the Bretton Woods loan conditionality has been reviewed within a broader political economy canvas (that is, incorporating the policy reforms alongside institutional and structural perspective). The following assessment is instructive:

“The structural transformation that is economic development can be achieved only by a sustained process of change based on actors who perceive their interests in making that change work through a combination of appropriate public and private incentives tailored to the history and institutions of the country in question. *While some key elements of the Washington consensus would be part of any such strategy, it came up short as a blue print for economic development*”¹⁴.

Despite these caveats, Besley (2005) claims that several of the elements of Washington consensus are as valid today as when they were initially conceived¹⁵. Indeed, there cannot be much dispute that several of the elements of Washington consensus, in as much as they seek macroeconomic stability, are useful prescriptions. It is, however, not that policymakers are unaware or ambivalent about stability being a precondition of sustainable growth, for that quantity and quality of growth can be hindered by a number of structural and institutional constraints. The critical caution in respect of stabilization, as many have pointed out¹⁶, is on establishing the appropriate degree of the measures and policy reforms, the adjustments needed, and the sequencing of policies that takes account of country-specific circumstances. More importantly, there is a need to appreciate how macroeconomic imbalances, in practical and pragmatic terms, ought to be reduced: that is, what policy instruments should a developing country, under immense resource-constraints, use to reduce prevailing imbalances. Evidence from country-level experiences is persuasive enough to suggest that over, the 1980s and 1990s, stabilization effectively amounted to “compression”, viz. rapid compression of fiscal expenditures (particularly, development expenditures) to reduce budget deficits;

¹² See Kalter et al (2004) for an account of how Chile combined stabilization reforms with other economic policies and appropriate institution-building.

¹³ Also see Williamson's own evaluation of how far the Washington Consensus has been misjudged, in Besley (2005)

¹⁴ See Besley (2005)

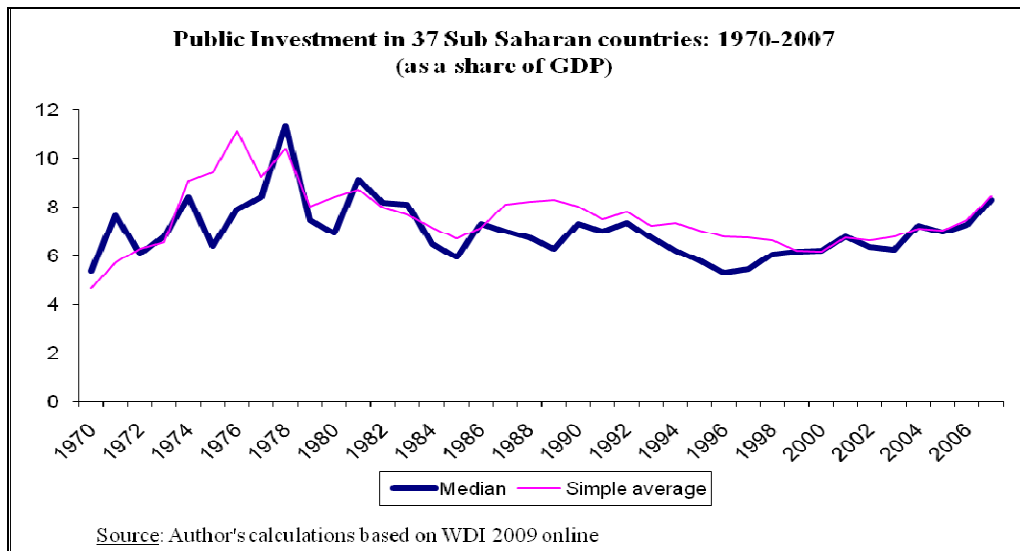
¹⁵ *ibid*

¹⁶ Banuri (1990); Taylor (1998); also World Bank (2005)

drastic curtailment of imports to reduce current account deficits; and restrictive monetary policy to contain inflation. Very few countries had during the early days of stabilization lending, the *policy* or *resource* space to seek alternative routes, such as through raising resource mobilization, expanding exports and productivity.

The consequences of the manner in which stability was achieved were, as many have noted, eventually led to disenchantment with policy reforms. *The instruments that were used to attain stability had clear trade-offs; the consequences of these trade-offs were not properly assessed or anticipated.* Restrictive monetary policies often led to hikes in interest rates which adversely affected investment; the elimination of import restrictions, apart from depriving governments of substantial revenues, affected industries and a country’s export-capacity; reduction in government expenditures badly affected development and various social transfer programmes, thus inhibiting growth of physical and social expenditures¹⁷. In addition, strict adherence to fiscal deficit targets led to a steady decline in public investment. The following figure shows the steady decline during the 1980s and 1990s in median public investment in the sub-Saharan countries (Figure 2).

Figure 2: Declining public investment in sub-Saharan Africa, 1970-2007



A steady decline in investment, a distinct fall in private consumption¹⁸ and public expenditures, and sluggish export performance – these coalesced to produce a fall in aggregate demand. The price of pursuing the elements of the Washington consensus both with respect to *targets* pursued, as well as *instruments* introduced to achieve the targets, has been largely a decline in aggregate demand. Dynamic efficiency has been traded off with “static” gains. In order to stave off crises of the kind mentioned by Besley (2005), the stabilization reforms in the developing countries led to a crisis of a different kind, i.e. a crisis of output and jobs growth. The above thus challenges the rather circumspect self-evaluation of the World Bank by arguing that in many countries

¹⁷ See Mckinley (2001); Ocampo (2002) among many others.

¹⁸ World Bank (2005)

the instruments (e.g. inflation and deficit controls etc) that were used to deliver static efficiency gains were themselves among the major reasons for growth failures. In other words, the processes set by the policy reforms, by ignoring the demand side of a country's economic activity, created the *raison d'être* for inefficient growth and employment outcomes.

4. Resurgence of growth 2002-07: What lessons for macroeconomic policy?

The beginning of the present century witnessed a distinct turnaround in the growth performance of the majority of countries across all continents. The period 2002-2007 in particular has been dubbed by Lin (2008) and others as one of global boom with the emerging economies leading the growth table.

While this period is under intense investigation and while various explanations are being forwarded to explain the sudden surge in growth (e.g. rise in global trade, FDI and financial flows, boom in commodity prices, etc), stabilization protagonists may, equally, claim success in explaining this growth. It may be recalled that efforts to establish a negative relationship between growth and the usual stability variables, that is, inflation, budget deficit and current account deficit have not been very convincing¹⁹. Despite mixed results, and unsatisfactory experiences²⁰ the stabilization doctrine, particularly through "inflation targeting" continues even today to dominate the macroeconomic policy design in many developing countries.²¹ Even after the Poverty Reduction Strategy Papers (PRSPs) came to the centre of the World Bank's concessional lending framework, the Bretton Woods institutions continued to remain focused on stabilization, without much attention to how the overall macroeconomic policy framework would support a poverty-reducing development agenda. In particular, there is country-level evidence to suggest that there could be tension and conflict between the PRSPs, and the two other facilities of the IFIs, viz. PRGF (Poverty Reduction and Growth Facility) and PRSC (Poverty Reduction Support Credit) through which orthodox stabilization measures were pursued²².

While, for the 1980s and 1990s the causality and/or associational relationship between growth and stability variables are observed to be amorphous, it may be interesting to assess these relationships during the more recent period of growth (i.e. 2000-2006). The following two graphs (Figure 3 and 4) depict the relationship between inflation and growth, for a fairly large sample of developing countries for which data are available for the period 2000-2006.²³

¹⁹ See Muqtada (2003) for some related estimates

²⁰ See Bredenkamp and Sehadler (1999)

²¹ For example, see Angeriz and Arestis (2008); also Epstein (2003)

²² See Khan (2006); for a review of the limitations of PRSPs see Muqtada (2003)

²³ For a detailed discussion on growth and price stability see Fischer (1993); World Bank (2005); Muqtada (2003); I. Islam (2009); Epstein (2003)

Figure 3: Inflation (<10%) and GDP growth, 2000-2006

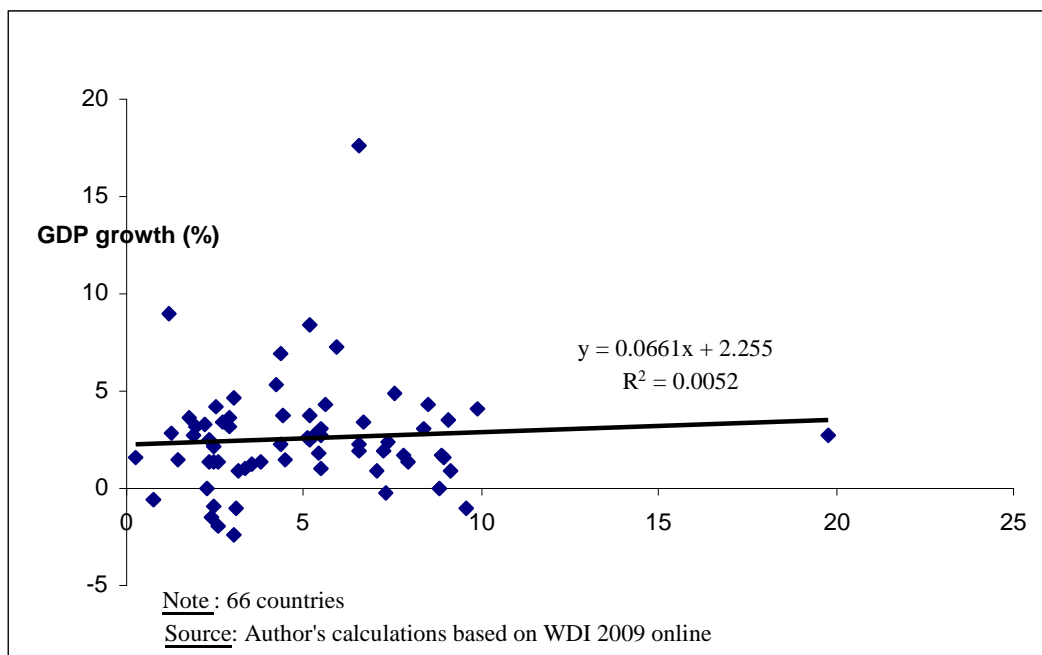


Figure 4: Inflation (<30%) and GDP growth, 2000-2006

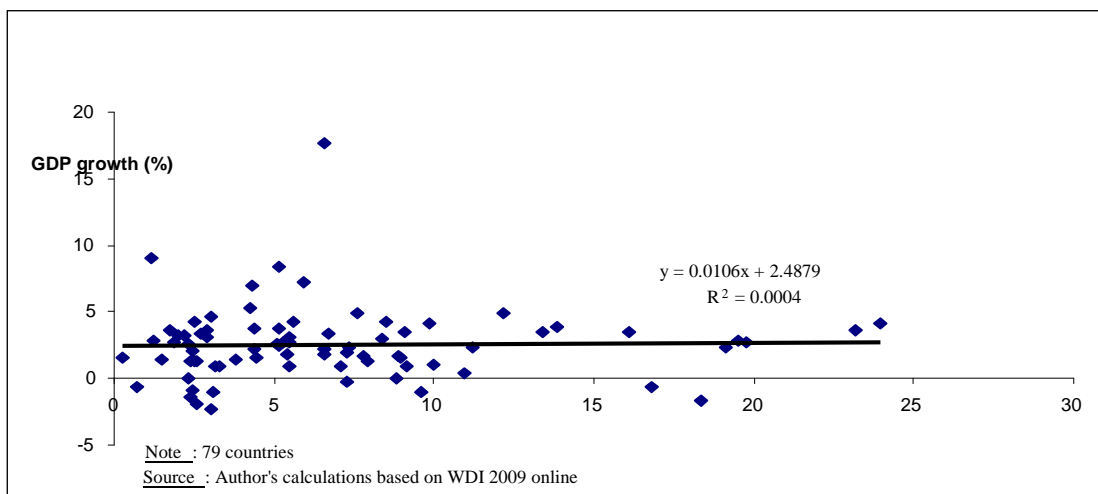


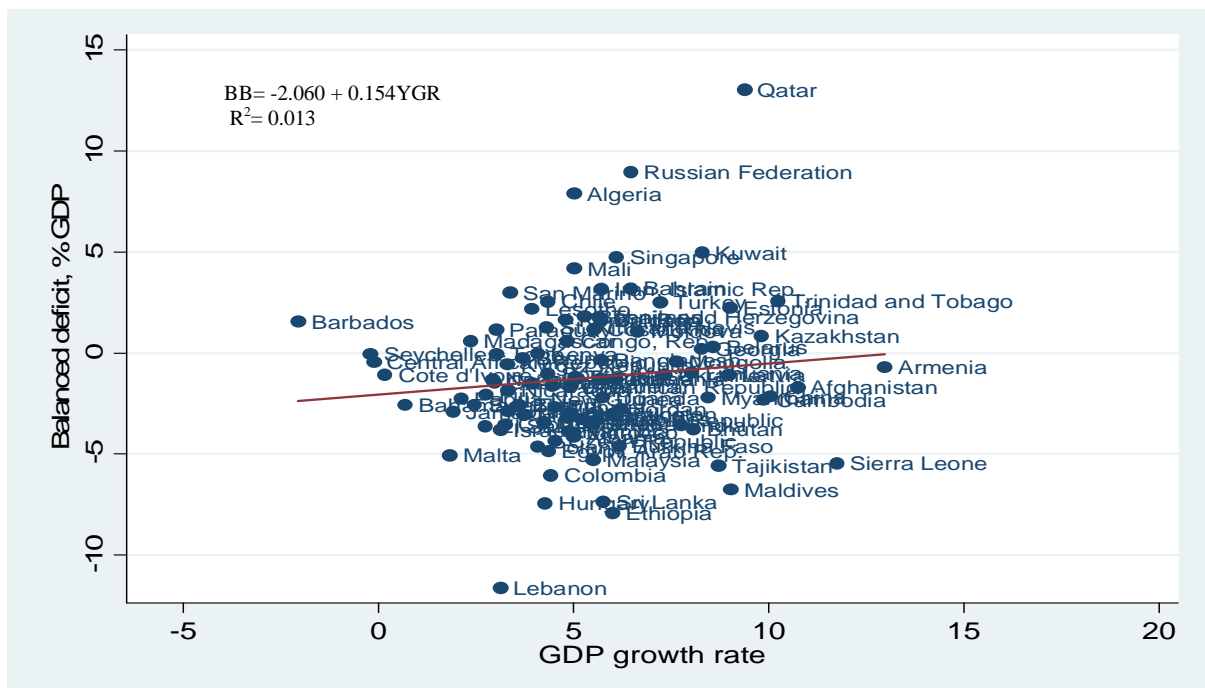
Figure 3 takes into account all countries that have registered inflation level of less than 10 per cent, while, the Figure 4 broadens the sample by taking into account a 30 per cent inflation level. Interestingly, both the situations suggest positive, though weak, relationship between growth and inflation. Muqtada (2009) has argued these results, at the very least, call for a nuanced view of the role of inflation and growth.²⁴ Particularly in developing countries with underutilized capacities, growth can be compatible with a mild rate of inflation (see below for a discussion on inflation thresholds) ; in fact, modest

²⁴ Also see Khan and Shenhadji (2001)

inflation is most likely to help mobilize resources. Historical structural and institutional factors all need to be reviewed in the context of each individual country's stabilization programme before setting restrictive inflation targets²⁵. Inflation thresholds, especially in the developing countries, could vary substantially owing to a number of price and non-price factors.

For the same growth period, we have also drawn a scatter plot to assess the relationship between growth and the two other off-cited stability variables, viz. budget deficit and current account deficits, both as per cent of GDP (Figures 5 and 6)²⁶. The relationship in both cases, contrary to the expectations of stabilization proponents, is observed to be positive, though not strongly significant. In fact, these findings and several other studies tend to suggest a modest budget deficit may well accompany, rather than hamper, growth, especially when a higher level of growth and poverty alleviation may warrant critical expenditures on infrastructure and social provisions²⁷.

Figure 5: Budget deficit and GDP growth rate, 2002-2006



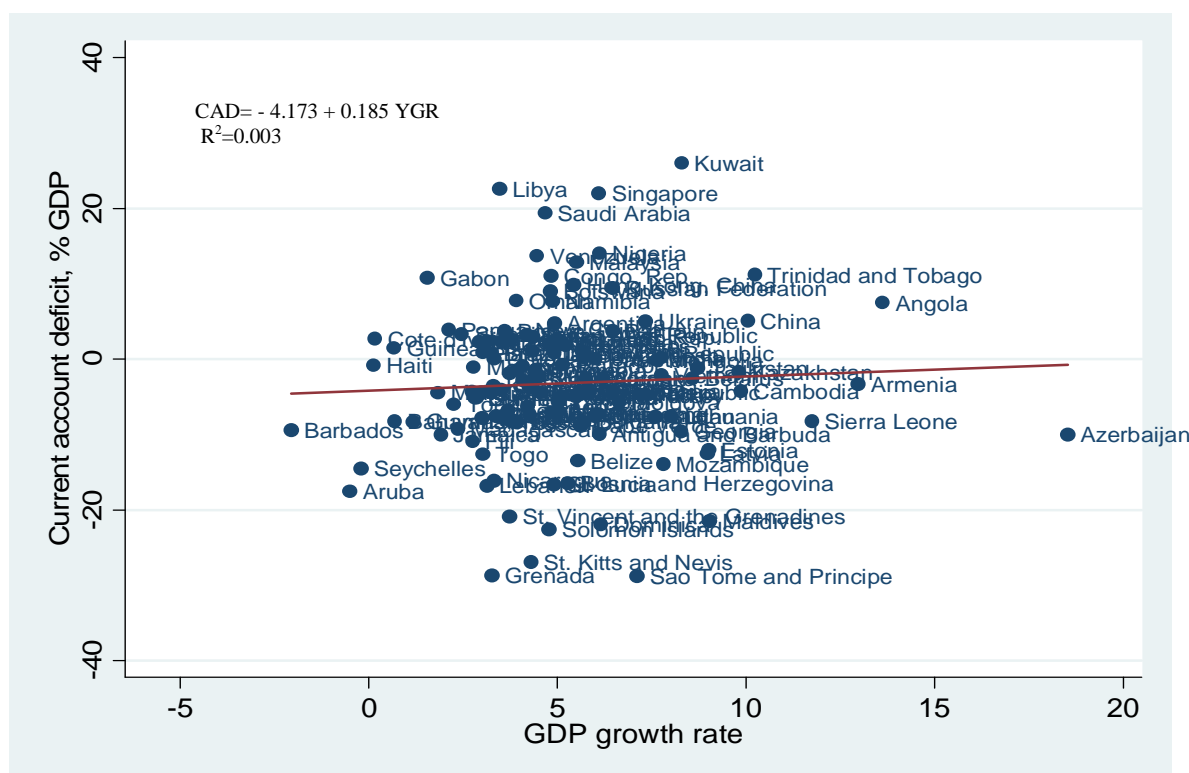
Source: The World Bank, WDI 2009

²⁵ See Banuri (1990), among others on role of institutions and group bargains in controlling inflation

²⁶ Also see Muqtada (2003)

²⁷ See Mckinley (2001)

Figure 6: Current account deficit and GDP growth rate, 2002-2006



Source: The World Bank, WDI 2009

Empirical estimates²⁸ reinforce the arguments made earlier: except a weak negative relationship with budget deficit, growth is seen to be positively related with the observed levels of inflation and current account deficit in the sample countries. According to these estimates, investment is again observed to be the significant explanatory factor of growth.

One may recall that the East Asian economies in their high growth era of the 1970s and 1980s, achieved investment-GDP ratios of more than 30 per cent. This was facilitated as much by macroeconomic stability as by public interventions in incentive structures, and physical and social infrastructures²⁹. High savings-investment rates, among other factors, together with a relatively egalitarian growth, helped these economies to achieve full employment and structural transformation. Such achievements would be less forthcoming when stabilization *per se* tends to return a low growth, rates of investment show declining trends, and the savings-investment gap continues to

²⁸ A regression of growth on inflation, budget deficit, current account deficit and investment generates the following estimates (pooled dated for 103 countries):

$$GDP = 0.347 (0.27) + 0.128Inf^* (2.91) - 0.035BD (-0.54) + 0.052CAD (1.37) + 0.169INV^* (2.93)$$

T-values in parentheses; * denotes significance at 5% level.

²⁹ For an identification of the conditions for greater private investment in developing countries, see UN (2001).

widen³⁰. This is precisely what had been happening, especially in Africa during the 1980s and 1990s, i.e. investment/GDP ratio was low, at around 20 per cent, while the savings rate was around 10 per cent (see Muqtada (2009))

Indeed one must note that, during the global boom of 2002-07, or even a few years before, the African economies did grow on a healthy rate. Investments grew as well. How far could this be attributed to *stabilization per se* that took place in many African economies? Without denying that African economies were much more stable at the start of the present decade, than in past two, one must note that the increase in growth was also strongly associated with the sudden boom in commodity prices, in the rise in foreign direct investment, and in the availability of resources released through major debt cancellations by the donor countries. Domestic investment rose only slightly but growth seems to have been spurred significantly through FDI (Figure A2 in Appendix). Overall, the investment ratio in sub-Saharan Africa is still far short of the levels attained by the East Asian countries during their high growth period.³¹

While macroeconomic, financial and institutional reforms would be needed to encourage stepping up of resource mobilization and domestic savings, most African countries are increasingly looking forward to FDI, and debt relief. For long-term growth, domestic investment would need to increase secularly. However, as we noted, investment growth would tend to depend on numerous factors, besides the stabilization indicators. This would call for broadening the “targets” in the macroeconomic policy designs.

5. Crises and macroeconomic policies

An immediate policy challenge during any major crisis is to bring the macroeconomic framework of the economy in order. Throughout history, crises appear to have induced major changes in existing policy measures to restore macroeconomic balances, and confidence in the markets. The rationale has been straight-forward, especially since many of the past crises, originating in a particular country have been induced by (either singly or through a combination of) inflation episodes, currency crisis, bloated public borrowings, or defaults in balance-of-payments. With the help of lessons drawn from the Great Depression and recovery, the advanced economies, during subsequent crisis, have tended to follow unorthodox policies, especially through lowering of policy rates and expansionary fiscal policies to restore consumer and market confidence.

The story has, however, been different for the developing countries. During the recent crisis episodes, policymakers, often under the aegis of the Bretton Woods institutions, were advised to follow orthodox pro-cyclical policies to restore macroeconomic stability. Such pro-cyclical policies usually included drastic reductions in public spending to curb budget deficits; hiking interest rates to contain inflation; and to compress imports to reduce current account deficits. In a situation of dramatic declines in GDP, such orthodox attempts to deal with macroeconomic instability could only reduce aggregate demand, thereby often accelerating the negative growth trends.³² This was indeed the situation in many recent crises: the case of the Asian financial crisis

³⁰ Griffin (2001) makes a persuasive call for an investment-led growth strategy for Africa.

³¹ For a recent assessment of relative issues, see Ndikunama and Verick (2008)

³² See for example Weisbrot (2007); Krugman (1998)

1997-98 stands out in particular. What apparently started as a currency crisis in Thailand (which had kept its currency pegged to the dollar despite its rapid depreciation) fast mutated into a full-scale financial crisis precipitated by a market panic from a rapid outflow of short-term capital.³³ The crisis spread to neighbouring Malaysia, Indonesia and South Korea which were growing at 7-8 per cent per annum in the previous years. Even such economies were reduced to near stagnation. Some of these countries, during the slump in growth, adopted pro-cyclical measures, largely advocated by the IMF, through bank closures, cuts in public spending and raising of interest rates – which further weighed down aggregate demand. In fact, investment/GDP rates in Thailand declined from 41 to 22 per cent in 1998.³⁴ It may be recalled that these economies, prior to the 1997-98 crisis, could hardly be faulted for not having sound macroeconomic fundamentals. Fortunately, these economies reversed their policy stances, largely through fiscal stimulus packages and lowering of interest rates, to restore growth. Thus, during economic downturns and recessionary tendencies, counter-cyclical measures, including a focused and well-targeted fiscal stimulus, is critical in raising/sustaining aggregate demand, GDP, growth and job creation. This lack of sensitivity in the stabilization policies, to how these may affect aggregate demand is not only a shortfall in the orthodox macroeconomic policy framework but is particularly perverse when a crisis-hit country is struggling to recover³⁵.

Let us turn to the recent global financial and economic crisis of 2008-2009, which came rather suddenly after an unprecedented period of global boom. This crisis, which has been triggered by house prices crash in the US, fast hit the country's banking and financial sectors, and spread rapidly to all other sectors of the economy. Due to the increasing global integration, the crisis spread to most countries of the world across all the continents.³⁶ This led to adverse employment and labour market outcomes, not only in the advanced countries, but also via several transmission channels, in many in the developing world (see Figure A3 in the Appendix for some comparative snapshots of increase in unemployment across the regions). The graph below shows one example of real economy effects of the crisis, that of Mexico.

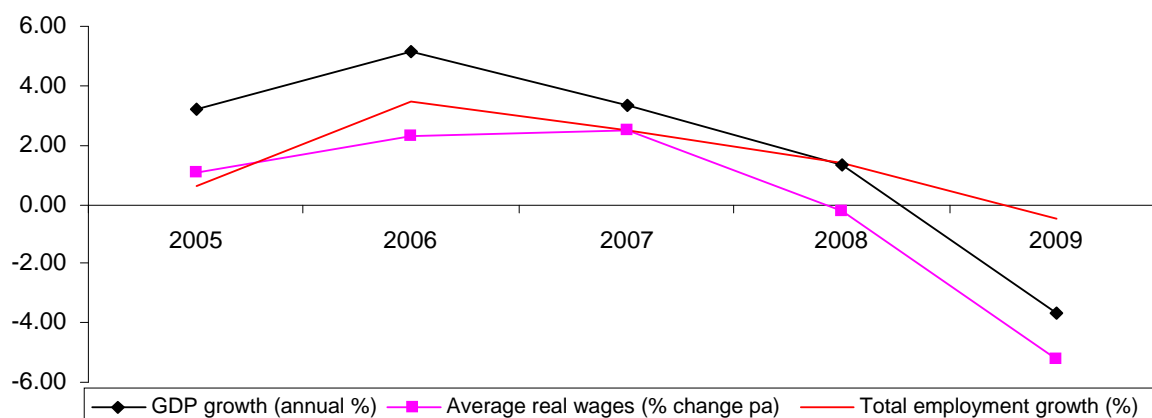
³³ See Lee (1998); also for a brief account in the social impact of the Asian crisis.

³⁴ Lee (1998);

³⁵ Krugman (1998)

³⁶ See Lin (2008); also Reinhart & Rogoff (2008)

Figure 7. Growth, employment and wages in Mexico



Macroeconomics of crises need to be framed in the context of the nature and causes of the crisis, and how and what it is affecting. The food security crisis, for example, that took place just before the financial crisis in 2008, created high inflation episodes in some countries. Policymakers in some countries were quick to conduct conventional, restrictive monetary policy to contain inflation, when in fact such price increases came about due to external “supply shocks”. Hailu (2009a) provides a graphic presentation of misplaced policy priorities in the case of Ethiopia.

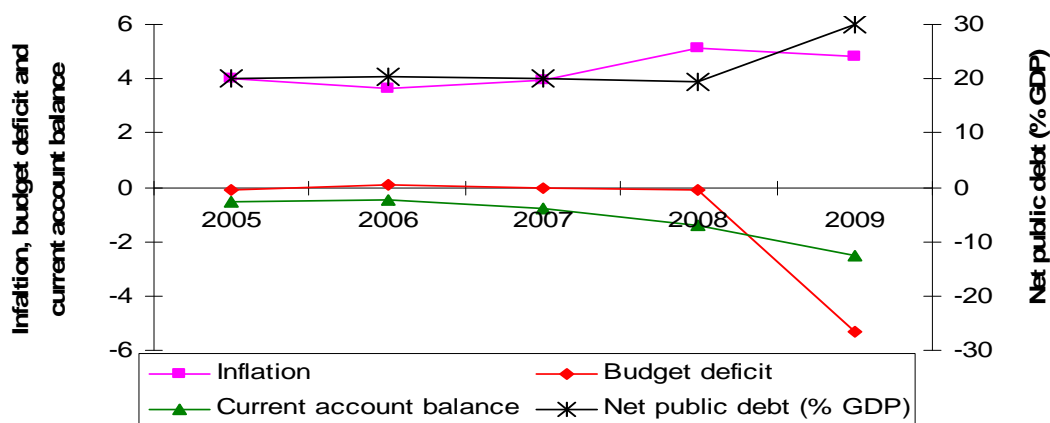
The recent global financial and economic crisis as faced by the individual countries is an externally-induced one, transmitted sharply through such channels as falling trade, financial flows, FDIs, remittances and ODAs. With reduced growth and falling revenues, many developing countries especially the LDCs in sub-Saharan Africa⁴⁰, would have little fiscal space to initiate a much-needed expansionary macroeconomic policy, not only to address the immediate vulnerable groups, but also to restore growth. This is precisely one consideration where a coordinated global macroeconomic policy could meaningfully address concerns of the developing world, viz. the enhancement of a fiscal space that could help the poor countries install some instruments of automatic stabilization. It is only the higher-order middle income countries, especially the emerging economies, which have, contrary to orthodox macro policies, undertaken substantial fiscal spending, largely based on “reserves” they have built up over the past few years. In these countries, public debts have gone up, and foreign exchange reserves have gone down;

⁴⁰ For a discussion of the critical importance of “fiscal space”, see ILO/IILS (2009).

depending on the duration and depth of the crisis and its impact, the macro fundamentals of some of these countries are already being threatened.

Again, to take an example from the recent experience of Mexico, the Figure below brings out the 2008 cut-off points, where relative stability has started giving way to crisis-induced macroeconomic *instability*. It is the relative reserve position, the debt-GDP ratio, as well as the pace of recovery that will determine the resilience of these economies. The rest of the developing countries, in the absence of external resources, would have to embark on an aggressive resource mobilization and fiscal consolidation not only to support the weak and fragile labour market and social protection frameworks, but also to finance a job-led recovery. Donor support may be absolutely crucial for some of the poorer countries, who may otherwise be left to tread the more risky route of down-sizing aggregate demand, in order to attain conventionally-established stabilization targets.

Figure 8. Macro fundamentals in Mexico, 2005-2009



Source: EIU, WorldData for budget balance and net public debt; IMF, World Economic Outlook Database, April 2009 for current account balance and inflation

Precisely, in a scenario where growth and employment are badly affected, pro-cyclical policies, to attain strict stabilization targets, can only aggravate the crisis situation. Unfortunately, the Washington consensus and the conservative macroeconomic policy stance continue to feature strongly in the Bretton Woods advocacy even during this present economic catastrophe. At the G20 London Jobs Summit, the IMF has sent out a strong caution to countries to adhere to macroeconomic stabilization, while at the same time acknowledging the necessity of the massive, coordinated fiscal stimulus packages pronounced by the advanced countries.⁴¹ For the latter, these anti-cyclical measures are seen as temporary, time-bound and targeted.⁴² Nevertheless, it would appear as “double standards” since the developing world, facing similar growth and jobs crisis, is de facto denied access to such measures. While containing debt-to-GDP ratio may be relatively easier for the developed countries, ways must be found to support

⁴¹ Chair’s Report of the London Jobs conference 2009 of the G20 countries (mimeo).

⁴² Muqtada (2009)

enhancing the *fiscal space* of developing countries in order to mount a fiscal stimulation of the economy. The various stand-by loan agreements that IMF has reached in the post-crisis period appear to suggest that the orthodox package of stabilization still continue to dominate such agreements. The recent agreement with Pakistan and Ukraine for example, are cases in point.⁴³ For developing countries, in times of crisis, these loan agreements need to contain and define the individual country's fiscal space to provide critical support, at least to sustaining incomes of the vulnerable groups. It must be noted, however, that the crisis has put the IMF and its orthodox policies under spotlight, and very recently the IMF has come around to acknowledge that a rethink of macroeconomic policy is required.

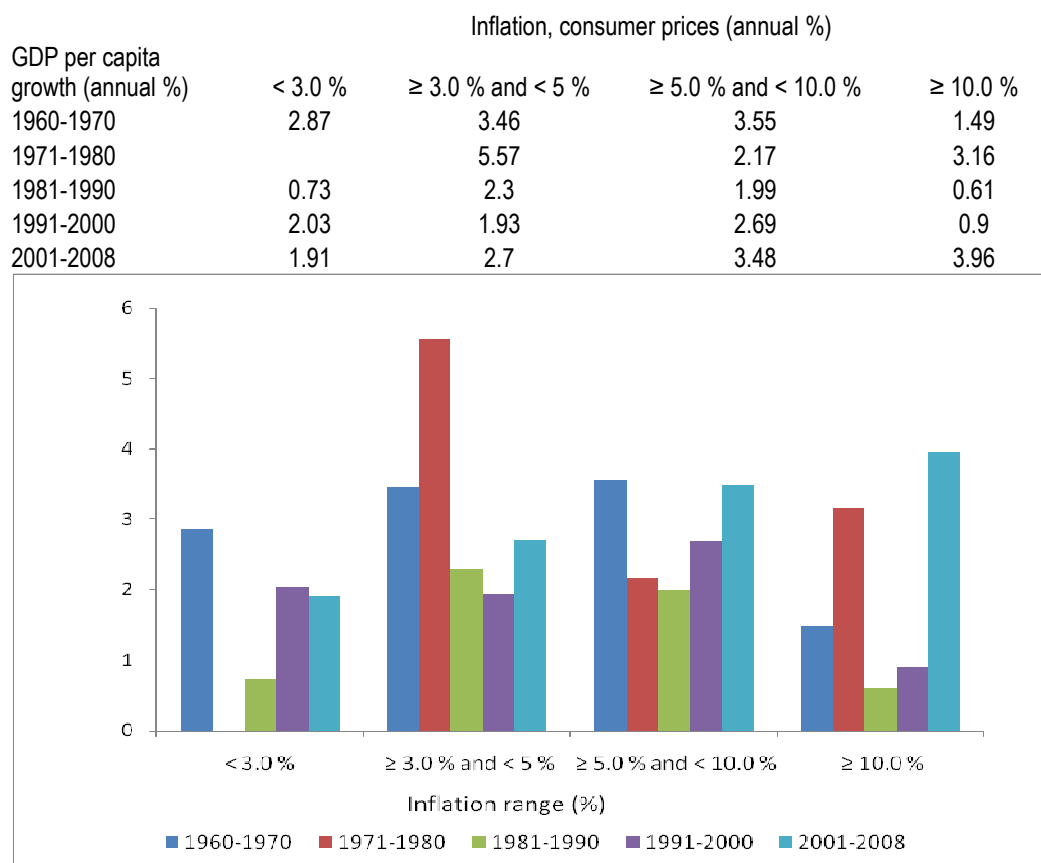
A recent staff position paper by Blanchard et al. (2010) provides possibly the first serious introspection by IMF on what has been a long and rigid IMF policy position with respect to macroeconomic strategy. The paper laments that "we (the IMF) thought of monetary policy as having one target, inflation, and one instrument, the policy rate" (p.3), thereby acknowledging (and as argued in our chapter) that there can be *multiple targets* in a macroeconomic strategy, and *multiple instruments* to attain these targets. In particular, the paper relents on the singular focus on inflation ("...behavior of inflation is much more complex than is assumed..." p.7) since macroeconomic stability (i.e. output and price moderation) can be affected by several other factors (see Muqtada 2003). What the paper fails to mention explicitly is the distinction between end-targets and intermediate targets of macroeconomic policy; and that price stability earned through strict monetary policy could not be sustained unless, as Keynes points out, aggregate output/employment was allowed to settle at less than full-employment equilibrium.

The paper thus recognizes the role of fiscal policy as a significant tool, especially in times of crisis when countercyclical measures are warranted, and when monetary policy often reaches its limits, as observed in Japan during the 1990s, and now, in the advanced economies during the 2008-09 crisis.

The paper is rather fleeting in the context of macroeconomic options for the developing countries; these are countries where IMF's conditional lending has been a major source of discontent. The paper's call for exploring the consequences of raising the target of policy rate from existing 2 per cent to 4 per cent may appear sensitive to the developed countries but, as we have seen earlier, such inflation targeting will still remain insensitive to the conditions prevailing in the developing countries. In fact, Khan and Senhadji (2001) suggest for the latter group of countries, an inflation threshold of 11-12 per cent beyond which growth will be hampered. We have estimated the following decade-wise table to show (i) the large variations that can exist in the inflation-growth relationship and (ii) to suggest countries (in 2008-09) which obtained close to 4 per cent per capita GDP growth had inflation of more than 10 per cent. The IMF stocktaking fails to acknowledge a distinction between "inflation targeting" and targeting a stable inflation level.

⁴³ See Muqtada (2009); Hailu (2009) states that IMF's recent stand-by loan agreements with 15 countries contain nearly 224 types of conditionalities, largely in the areas of fiscal reforms; financial liberalization, trade reforms, price liberalization, privatization etc.

Figure 9. Median of GDP per capita growth under various inflation range



Source: World Bank, WDI 2009, Author's computation

Finally, the paper is strikingly silent on the entire question of full-employment as an objective (target) of macroeconomic policy, and how output stability could be sustained without appropriately addressing issues related to sustaining/increasing aggregate demand. Nevertheless, the paper marks important first steps in re-evaluating the manner of how the IMF's conditional lending needs to operate.

6. Towards an employment-focused macroeconomic policy

As we have observed, macroeconomic policy designs in developing countries, often under “conditionalities” of loan agreements with the Bretton Woods institutions, had effectively become *uni-dimensional* (i.e. largely focused on “inflation targeting”), without adequate considerations of various other targets of macroeconomic policy framework. Economic growth was seen contingent on a country's ability to attain macroeconomic stability; while the various goals of development such as job generation, labour market outcomes, and social progress effectively became hostage to such reforms.

The onset of the PRSPs purported to place “poverty reduction” at the centre of World Bank's lending to heavily indebted countries, did not quite rationalize a macroeconomic framework that firmly addressed a poverty-reducing employment-

centred growth. However, the PRSP process, almost by default, triggered a complete rethinking of the development strategy. Development was back on the agenda, with the increasing recognition that an employment-friendly growth pattern is the relatively surer way to attain sustained poverty reduction in an economy.⁴⁴

The achievement of full employment, however, is inherently related to a gamut of economic and social policies. ILO (1999) underscores two “precepts” that would contribute to moving an economy toward full employment: (i) “achieving economic growth of the type that makes good use of the assets which the poor own (i.e. labour)...”; and (ii) “any strategy for full employment must be based on a sound macroeconomic framework”. Thus, pursuing and designing a full employment strategy would essentially lie in articulating a combination of economic policies (*including macroeconomic*) and social policies which would fully engage the labour force in expanding productivity, and develop the necessary institutional framework for achieving simultaneously freely chosen, productive employment, fundamental rights at work and adequate income from work and social protection.

It would be only logical to presume that if macroeconomic policies were to be embedded in a country’s development strategy, which focused on productive employment generation as the tested path to reduce poverty, then employment would need to be at the centre of macroeconomic policy design. As we observed earlier, in the advanced economies, in the immediate post-Second World War period, the goal of achieving full employment was a key objective in their macroeconomic framework. Only when these economies attained nearly two decades of uninterrupted growth, and a situation of near full employment, the debate on macro policies became intense on whether, and how far, inflation or employment should become the dominant focus of such policies,⁴⁵ such as would keep aggregate supply and demand in a balance. As Brown (2002) has pointed out, the roles of macroeconomic and microeconomic policies appear to have reversed over time, i.e. macroeconomic policies, which during the 1950s and 1960s targeted full employment, shifted to targeting inflation and prices during the 1970s and 1980s. Microeconomic policies which in the earlier periods had been used in containing inflation (particularly through wage moderation), is now being charged with the responsibility of promoting employment and employability (e.g. through active labour market policies). This change in roles of macro policies has to be viewed in the context of the changing assumptions in respect of an individual country’s growth and employment situation. The debates on what should be the key objectives of macro policies must not get mired in a rather simplistic ideological positioning. The advanced economies, already saddled with unacceptable levels of unemployment, are now facing a major employment challenge after the recent crisis. As in the case of EU, although the Maastricht Treaty stipulates stringent stability requirements, large unemployment rates in many countries have kept the debate alive on how measures could be undertaken to enhance aggregate demand, and thereby sustain labour demand.⁴⁶ The crisis of 2007-2009 which has led to a significant rise in joblessness, has underscored the need for a coordinated, expansionary macroeconomic policy design for the region.⁴⁷

⁴⁴ See R. Islam (ed., 2006) for an exposition of the growth-employment-poverty nexus.

⁴⁵ See Jackman’s article in Khan and Muqtada (1997).

⁴⁶ Ibid

⁴⁷ Cf. ILO (1999).

A shift in the key emphases in the macroeconomic policy framework would, of course, imply a shift in the trade-offs that a country's policy planners would desire. The critical issue here must be one of *pragmatism* and *policy coherence*. Guidance to macro-design must, therefore come from a simple, appropriately-assessed empirical situation of the individual economy. The experiences of macroeconomic policy design, during the past six decades, with their variable outcomes, in both the developing and advanced economies, have produced an adequate knowledge base that could inform current policymaking with pragmatic lessons. One such pragmatic lesson appears to be to avoid one-size-fits-all targets; also that instruments to achieve these targets could vary from country to country.

The crisis of 2008-09 has placed a further onus on the design of macroeconomic policies, viz. to incorporate measures to reduce volatility of growth, as well as volatility of employment and incomes, especially of the vulnerable groups. While such volatility can be triggered by external shocks, national policies and institutions need to be in place to ensure protection, especially the vulnerable groups. Even in the case of some of the relatively strong economies of Asia, the pervasive impact of the 1997 Asian crisis on the world of work exposed a common lacuna, viz. the weak and fragile labour market and social protection frameworks.⁴⁸ The huge toll in terms of worker lay-offs, loss or reduction of earnings and wages, etc, forced governments to undertake an array of social safety net measures. The global financial crisis has further underscored the increasing need to establish social security systems⁴⁹ in the developing countries. While this has been echoed in various platforms, e.g. at the recent G20 meetings, as well as by multilateral organizations (e.g. World Bank's "vulnerability fund"), there needs to be a clearly-defined national blueprint on how such a system could be developed and financed. Countries with adequate fiscal space, such as China, India, Brazil, have embarked on various safety net and social protection measures, though not in the usual precept followed in the advanced economies.

The arguments above, as well as those made in the previous sections of this paper tend to clearly suggest that there needs to be a serious rethinking on the goals of macroeconomic policy, as well as on the instruments through which the goals can be attained. The following, stated at the risk of some repetition, are, *inter alia*, a few considerations :

- (i) A foremost imperative of macroeconomic policy design is a renewed commitment to the goal of full employment. In the case of developing countries, where job-generation towards poverty reduction will continue to dominate the development agenda for quite some time, macroeconomic policy design, without an unambiguous weight to employment objective, would be a "highly risky method of policymaking".⁵⁰ c. The *uni-dimensional* perception of macroeconomic policies, (such as "inflation targeting"), hitherto practised under the stabilization programme, needs to be replaced by a macroeconomic strategy that would incorporate the pursuit of full-employment.

⁴⁸ For a detailed account, see Lee (1998), op. cit.

⁴⁹ An example is ILO's campaign towards a global "social floor". (see ILO' Global Jobs Pact in ILO 2009)

⁵⁰ See A.R. Khan (2006).

- (ii) The need to incorporate employment in a macroeconomic policy framework would warrant the appropriate introduction of multiple targets, the relative weights of which would depend on country-specific circumstances. The contours of such a multi-dimensional perception can be seen in the cases of East Asian economies, as well as Chile, where macro-fundamentals were achieved in tandem with macroeconomic support toward investment and savings; further, such a policy framework also ensured an equity-sensitive growth pattern that helped support a faster pace of poverty reduction.
- (iii) Regarding the setting of target(s), there must be convincing basis of how the threshold of the target(s) is defined. As we have observed earlier, a major difficulty with IMF's stringent position on stabilization was with respect to their adherence to "inflation targeting", (eg less than 2 per cent) rather than on trying to achieve a stable and moderate *level* of inflation (eg Khan and Shenhadji(2001) who estimate 11-13 per cent as the threshold for developing countries). In the case of the latter, various instruments would be at play, depending on the accuracy of analysis of the root causes of inflation, and how it may affect other macroeconomic variables.
- (iv) Given that the dominant target of orthodox macro-policy was price stability, there was an over-riding role of monetary policy in their advocacy, viz through the policy rate. It is now well-known, especially in the aftermath of the recent crisis, fiscal policy needs to play an equally significant role, not just as a counter-cyclical instrument in short-term business cycles, but also in longer term allocative functions toward growth and equity. "Fiscal discipline" (à la Washington Consensus !) must not be conflated with fiscal policy, and the proactive role that this instrument can play in both stabilization and growth processes. A fiscal stance would also need to be mindful of building up a fiscal surplus during periods of good growth, in order to cushion economies during a crisis.
- (v) Another imperative of macroeconomic policy, as crucially highlighted by the recent crises, is on the need to incorporate measures to reduce volatility of growth, and to offset jobs and income insecurity that it entails. This would warrant adopting a range of social protection and safety net measures. Though initially, these may be rudimentary in scope and coverage, such social protection systems when internalized in a macroeconomic framework would, apart from reducing insecurity, tend to act as important stabilizers of the economy, especially through sustaining consumption and aggregate demand during recessionary periods. This, in fact, is at the heart of the "automatic stabilizers" in the macroeconomic policy design of the advanced welfare economies. The poorer developing countries, which during crises usually resort to (often with donor support) discretionary interventions and extensions of existing safety net programmes, need to make their first assessments at what it would take to install a basic social protection system, one that their macroeconomic policy design could incorporate as an approximate automatic stabilizer.

7. Concluding remarks

The debates on the design of macroeconomic policies have largely been inspired by the ideological divide between demand-side and supply-side approaches to economic performances, both in the context of advanced industrialized countries, as well as of the developing countries. In particular, the strict version of macroeconomic stability inspired by the Washington Consensus came to be challenged, both by the development strategists, as well as by the dismal country experiences of the 1980s and 1990s. The latter in particular have echoed the need for formulating a macroeconomic policy framework that would need to be country-specific, and pragmatic, and one that would be embedded in the development strategy of the individual country. Orthodox macroeconomic stabilization policies largely focused on price discipline (“inflation targeting”) leaning on economic levers to ease supply constraints. The fundamental inadequacy of this framework is their lack of understanding of what Krugman (1999) called the “failures on the demand side of the economy”. For developing countries in particular, especially those with large surplus labour and poverty levels, a prudent use of monetary and fiscal levers would be needed to address the critical goals of attaining fiscal space for focused public interventions toward enhancing growth, employment generation and social protection. Indeed, such levers also would need to ensure macroeconomic targets that are defined by the economy’s toleration limits (of inflation and fiscal deficits).

In a final analysis, a macroeconomic strategy would essentially constitute the individual country’s political charter in as much as it would require making a collective choice on how it wishes to pursue its development agenda that is defined by the goals of employment generation and poverty alleviation. Its design and implementation would have to be seen against ground realities of institutions and stakeholders’ coalition in the individual countries. Macroeconomic strategy would continue to involve making hard choices on potential trade-offs, such as between employment and inflation; social transfers and fiscal space; tax policies and incentive structures.

A macroeconomic policy framework would thus not only entail consensus-building among various stakeholders, but also reforms in institutional and decision-making processes towards policy coherence. One way of developing such a consensus is a modified mandate of the macroeconomic policy managers, currently the central bank and finance ministry, to formally endorse the goal of “free and productive employment and decent work for all” as enshrined in the MDGs.⁵³ The “crisis before the crisis”⁵⁴, which was characterized by dismal employment and labour market outcomes, as well as the 2008-09 crisis, which has increased the incidence of vulnerable working population, should be powerful reminders why the course of macroeconomic policy design and management needs to change.

⁵³ See Epstein (2003); Muqtada (2003)

⁵⁴ Cf. ILO / ILS (2009)

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Appendix

Figure A1: Frequency distribution of inflation rates (1980-2006)

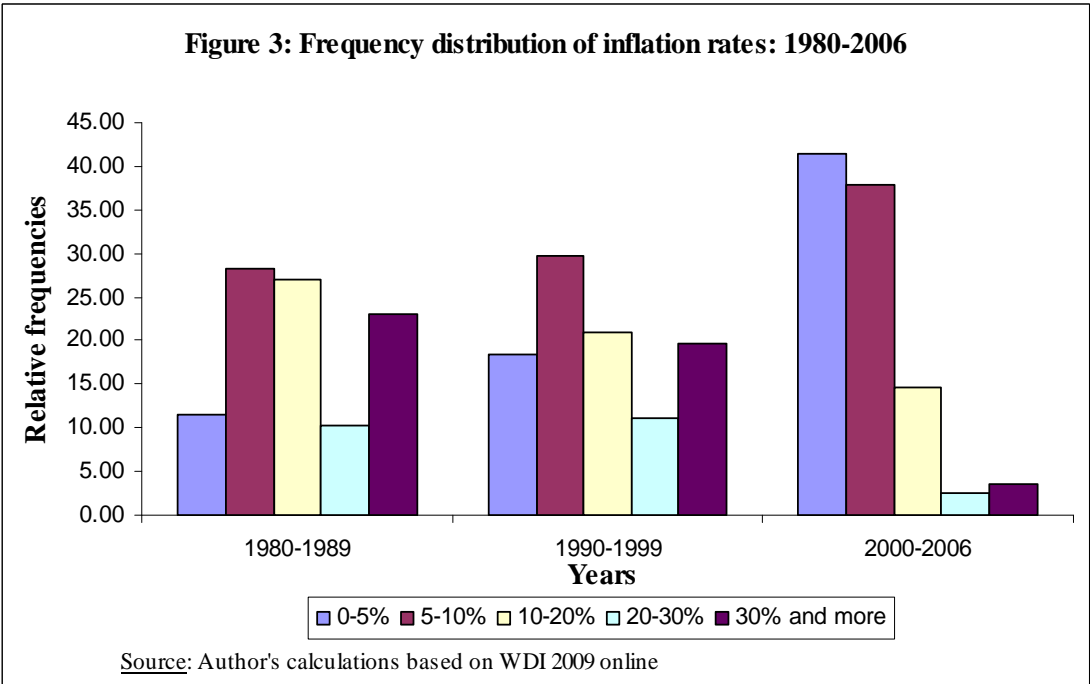


Figure A2: Trends in foreign direct investment in sub-Saharan Africa (% of GDP)

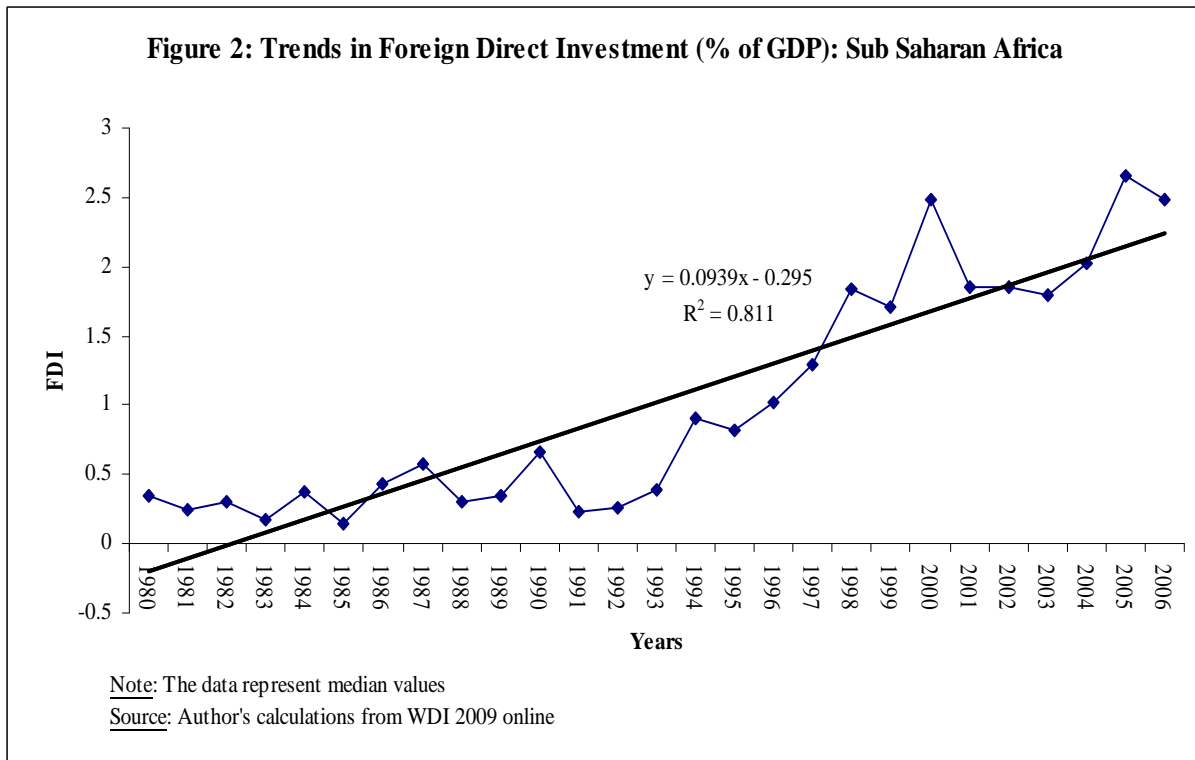
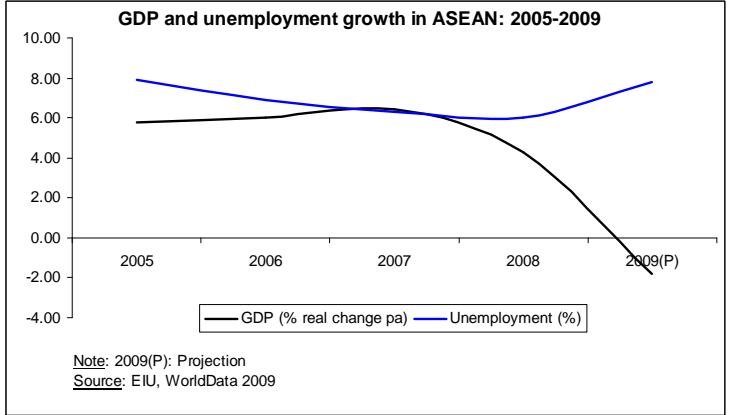
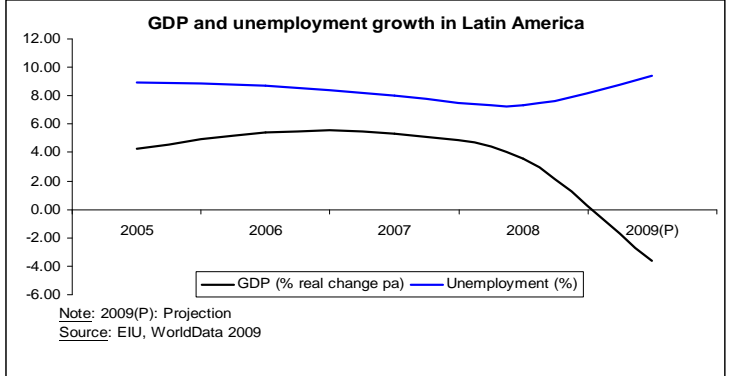
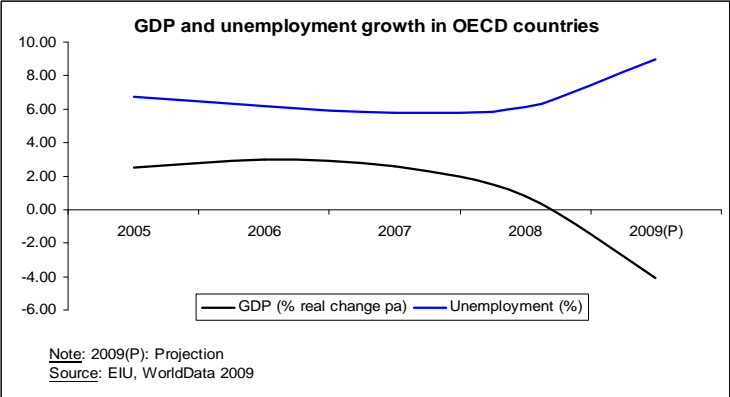
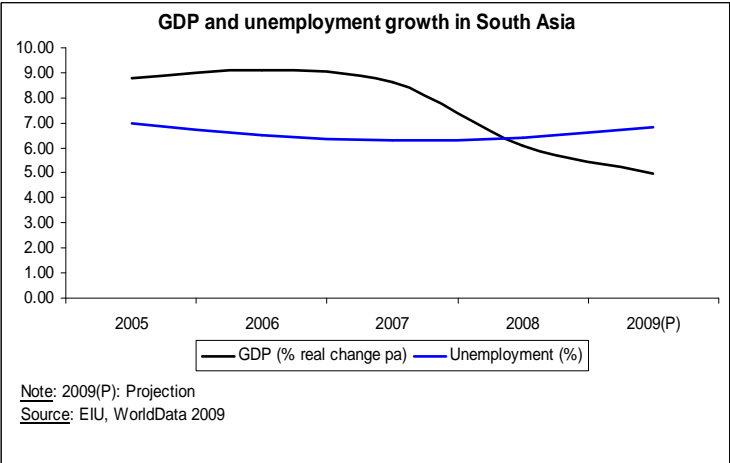


Figure A3: GDP and unemployment growth: Inter-regional comparisons



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