MACROECONOMIC POLICIES

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Abstract
The global economic crisis has created an opportunity to rethink macroeconomics policies for development. Such rethinking is both necessary and desirable. It is essential to redefine macroeconomic objectives so that the emphasis is on fostering employment creation and supporting economic growth instead of the focus on price stability alone. It is just as important to rethink macroeconomic policies which cannot simply be used for the management of inflation and the elimination of macroeconomic imbalances, since fiscal and monetary policies are powerful and versatile instruments in the pursuit of development objectives. In doing so, it is essential to the overcome the constraints embedded in orthodox economic thinking and recognize the constraints implicit in the politics of ideology and interests.
Key words
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It is bound to be said that governments in developing countries do not have much fiscal flexibility in either revenue or expenditure. Tax revenues are based less on direct taxes and more on indirect taxes. The base for taxation is not broad enough. Tax compliance is low, which is attributable to tax avoidance and tax evasion. Thus, governments find it very difficult to increase their income through tax revenues. Orthodoxy does not help matters. For, typically, tax rates are lowered without any systematic effort to improve compliance or broaden the base for taxation.[15] In the sphere of expenditure, governments find it difficult to cut consumption expenditure, so that the axe falls on public investment, which constrains growth, and on social sectors, which hurts the poor. But there is policy space which must be used and not given up. And things change for the better, through a cumulative causation, in the process of development. Public investment develops infrastructure and crowds-in private investment, both of which are conducive to growth, while expenditure on social sectors, education and health, is more investment than consumption, which can raise productivity. Government expenditure has multiplier effects that also creates revenue through buoyancy. As institutions develop and development accelerates, fiscal flexibility increases.

Monetary policy in developing countries also has limits. Money markets are often segmented, if not underdeveloped. Effects of monetary policy are more narrowly directed. Its effectiveness is lower. Open market operations are obviously a limited option in thin markets. Experience shows that beyond a point higher interest rates do not combat inflation just as lowering interest rates does not stimulate investment. Interest rates are a strategic instrument to influence allocation of scarce investible resources.[16] And the volume of credit could be more effective than the price of credit as an instrument of monetary policy. But the deregulation of domestic financial sectors and capital account liberalization, taken together, have reduced the space for monetary policy. This needs correction. Monetary policy should not be narrow in its objectives (managing inflation alone) and as an instrument (just interest rates). In fact, there is need to create space for monetary policy in the pursuit of development objectives. As financial markets develop, institutions evolve and instruments diversify, monetary policy can become more effective in terms of range and reach.

It is also important to recognize the somewhat different macroeconomic implications of the interaction between fiscal and monetary policy in developing countries.[17] For example, the monetary impact of fiscal policy is perhaps greater in developing countries because a much larger proportion of the fiscal deficit is financed by borrowing from the central bank. In a shallow capital market, the alternatives are few and far between. And, in developing countries, borrowing from the central bank is the principal source of reserve money which makes it the most important determinant of monetary expansion. This is no longer the case in most Latin American economies, but remains the reality in most other developing countries. Similarly, the fiscal impact of monetary policy is perhaps greater in developing countries, because, in situations where public debt is large as a proportion of GDP and interest payments on these debts are large as a proportion of government expenditure, even modest changes in interest rates exercise a strong influence on fiscal flexibility.

In a changed international context, it is also important to recognize that countries which are integrated into the world financial system are constrained in using an autonomous management of demand to maintain levels of output and employment. Expansionary fiscal and monetary policies - large government deficits to stimulate aggregate demand or low interest rates to encourage domestic investment - can no longer be used, as easily as in the past, because of an overwhelming fear that such measures could lead to speculative capital flight and a run on the national currency. The problem exists everywhere. But it is far more acute in developing countries.[18]

There are important lessons to be learnt from the experience of financial deregulation and capital account liberalization, in both industrialized countries and developing countries, about what should not be done.[19] It is clearly essential to learn that financial deregulation, such as doing away with the distinction between banking and non-banking financial intermediaries, is fraught with risk. At the same time, in thinking of integrating with international financial markets, it is clear that it would be wise to hasten slowly with capital account liberalization. For the same reason, it would be unwise to rely on portfolio investment inflows to finance current account deficits because portfolio investment represents the intersection of two somewhat thin, very unstable, markets in developing countries:

namely stock exchange markets, and foreign exchange markets. Indeed, wherever countries have moved to capital account liberalization, the option of introducing capital account controls must be retained.[20]

Macroeconomic policies are neither formulated nor implemented in a vacuum. It is, therefore, important to recognize the significance of the political context. What governments can or cannot do in the sphere of macroeconomic policies is also shaped in the realm of politics. It is an outcome of the ideology, the institutions and the interests that reinforce orthodox theory and practice.

Ideology: The gathering momentum of globalization, associated with an internationalization of financial markets, led to the formulation of a rationale for orthodox macroeconomic policies that is almost prescriptive. The objectives of price stability and fiscal balance became sacrosanct, which defined the role of monetary policy and fiscal policy in the narrowest possible sense. Slowly but surely, this orthodoxy was embedded in the belief systems of individuals, who influenced policy and shaped opinion, in politics and government. In this process, intellectuals from the world of academia provided the rationale and editors or columnists from the world of media provided the voice. It is no surprise that the orthodox belief system was transformed into a virtual ideology.

Institutions: The ideology is not abstract. It is in the logic of international financial markets, where price stability is almost an article of faith, high interest rates ensure profitability and strong exchange rates impart confidence. Orthodox macroeconomic policies are simply a means to these ends. The same worldview came to be adopted by multilateral financial institutions, in particular, the IMF and the World Bank, which exercised enormous influence on policies of economies in crisis. It was only natural that this thinking spread to national institutions. The advocacy may have come from domestic financial sectors, but the policies were formulated by finance ministries while the practices were adopted by central banks.

Interests: Governments in developing countries find it very difficult to increase their income through tax revenues, because important political constituencies with a voice have the capacity not only to evade or avoid taxes but also to resist taxes. In contrast, governments in developing countries find it somewhat less difficult to decrease their expenditure, although there are asymmetries. It is easier to cut investment expenditure than to cut consumption expenditure, just as it is easier to reduce public expenditure on social sectors where the economic constituencies are not as organized as elsewhere and the consequences are discernible only after a time lag. There is a similar intersection of economics and politics in the sphere of monetary policy.[21] The orthodox view does recognize this but the recognition is limited to the macroeconomic significance of monetized deficits and the independence of central banks.[22] This understanding and characterisation is much too narrow. Clearly, the dominance of one institution over another could be dangerous, for it takes away checks and balances. But autonomy or independence is not the answer. Macroeconomic policies for development require partnership and coordination. In any case, there is more to the political economy of monetary policy. Constraints embedded in political economy reduce degrees of freedom in the use of interest rates. Property-owning democracies with extensive rentier interests, in developing countries, almost as much as in industrial societies, prefer higher interest rates not only because of higher income from financial assets but also because a wider middle class fears that inflation might erode the real value of their accumulated savings. In developing countries that have carried out capital account liberalization, sources of foreign capital inflows also prefer higher interest rates and lower inflation rates. It is not surprising, then, that any lowering of interest rates is resisted by an emerging rentier class in domestic financial markets which has a political voice, just as any lowering of interest rates is constrained by an integration into international financial markets which also become significant political constituencies for finance ministers.

Over the past three decades, the focus of macroeconomic policies, everywhere, has become narrower with the passage of time. In industrialized countries, the traditional objectives were internal balance and external balance.[1] Internal balance was defined as full employment and price stability, that would be conducive to economic growth. External balance was defined as equilibrium in the balance of payments primarily with reference to the current account. The decline of Keynesianism and the rise of monetarism in the mid-1970s led to a profound change. The conception of internal balance came to be confined to price stability, so that full employment was no longer an integral part of the objective. This was partly attributable to the belief that if the government achieves price stability, then the market will automatically achieve full employment. Since then, the notion of external balance has been progressively diluted in a world of capital account liberalization. In developing countries, the traditional concern was economic growth in the long term, subject to the constraints that inflation remained within limits of tolerance and that the current account deficit in the balance of payments remained within manageable proportions. The focus of policies shifted to macro-management in the short term after many developing countries, to begin with in Latin America during the early 1980s, ran into debt crises or other forms of macroeconomic disequilibrium. Again, the reason put forward was that if the government succeeded in achieving price stability in the short run, all else including growth would follow. The presumption that full employment and economic growth would materialize as corollaries was belied by experience in both industrialized and developing countries.[2]

Macroeconomics was developed in, and for, industrialized economies. Theory and policy were both concerned with how monetary and fiscal policies should be used to attain stipulated objectives. The narrow focus led to an apparent convergence of objectives. Hence, this corpus of knowledge was sought to be used in developing economies without any significant modification. Such transplantation was simply not appropriate for two reasons.[3] First, the nature of relationships (between

variables) and the direction of causation (what determines what) in macroeconomics are both a function of the setting or the context. The starting point for any macroeconomic analysis is the distinction between exogenous and endogenous variables or that between autonomous and induced changes. Such a distinction is essential in macroeconomic theorizing which seeks to analyze implications and prescribe policies. It is important to recognize that this distinction is derived not from the analytical structure but from the institutional setting of models.[4] Second, there are systematic differences in the structural characteristics of developing economies as compared with industrialized economies. These span a wide range from differences in the constraints on output expansion, the degree of wage-price flexibility, the sources of growth, the development of financial markets, institutions and instruments, or the capacity of governments to finance their deficits, to the ability to cope with shocks and crises.[5] There are also significant differences among developing countries. And even if some laws of economics are universal, the functioning of economies can be markedly different. Therefore, good economic theory and good policy analysis should recognize, rather than ignore such myriad differences. But orthodox thinking, which became dominant, simply ignored these differences.

Until the early 1980s, macroeconomic policies in developing countries were embedded in broader growth-oriented development strategies. These policies recognized the differences in structural characteristics of economies and incorporated a longer term perspective. But this approach changed for two reasons. First, macroeconomic instabilities and crises in developing countries surfaced and spread. Second, there was a shift from the Keynesian consensus on counter-cyclical demand management for full employment to the more conservative monetarist view that sought to control inflation. The control of inflation and the elimination of (internal and external) macroeconomic imbalances became the essential objectives. Orthodoxy stressed the importance of a stable macroeconomic environment. Macroeconomic policies sought to focus on stability, defined largely in terms of prices. Short term stabilization, in a narrow sense, came to be seen as the path to long term growth. This new orthodoxy prevailed as it was imposed on economies in crisis by the IMF and the World Bank and was reinforced by international financial markets. Inflation was reduced and fiscal balances were restored. But this did not contribute to higher or faster growth. Indeed, stabilization often induced pro-cyclical macro policies that squeezed or stifled public and private investment and thereby hurt economic growth.[6]

There were voices of dissent. Heterodox critics questioned orthodoxy. Yet, nothing changed. However, the dominant ideology of our times has been dented, if not discredited, by the global economic crisis. And it is beginning to lose its stranglehold on thinking, at least in political processes, if not in the ivory towers of academia. There is a growing recognition that markets are no magic wand, that the invisible hand of the market is not visible because it is not there, and that markets are good servants but bad masters. It is clear that the financial crisis and the persistent recession provide an opportunity to rethink macroeconomic policies.[7]

Such a rethinking must begin by redefining policy objectives. In the short-term, or in crisis situations, the prime concern should not be the stability of prices alone. The stability of output and employment is just as important. In the medium-term, or in normal times, the essential objective of macroeconomic policies cannot simply be the management of inflation and the elimination of macroeconomic imbalances. It should be just as much, if not more, about fostering employment creation and supporting economic growth. The rethinking must also extend to reconsidering policy instruments. Fiscal policy cannot be reduced to a means of reducing government deficits or restoring macroeconomic balances. It is a powerful instrument in the quest for full employment and economic growth. Monetary policy cannot be reduced to a means of controlling inflation through interest rates. It is a versatile instrument where both the price and volume of credit can be most effective in the pursuit of development objectives.

In sum, it is essential to return a developmental approach to macroeconomic policies, which is based on an integration of short-term counter-cyclical fiscal and monetary policies with long term development objectives. This should shift the focus from the financial sector to the real economy, from the short-term to the long-term and from equilibrium to development. Economic growth with full employment should be the fundamental objective of macroeconomic policies. Given the differences in the quality and maturity of institutions, the framework for macroeconomic policies in developing countries, in terms of objectives, instruments or stance, would have to be different from that in industrialized economies. Macroeconomic policies in the developing world also need a broader approach insofar as the nature and sources of growth are different in the two sets of countries.