



Discussion Paper 2405

Pro-Poor Monetary and Anti-Inflation Policies: Developing Alternatives to the New Monetary Policy Consensus*

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Introduction

This research paper critically reviews the New Monetary Policy Consensus (NMPC) and outlines pro-poor alternatives to the mainstream policies associated with it.¹ The paper is divided into five sections. The first outlines the NMPC and its key policy recommendations, inflation targeting (IT) and central bank independence (CBI), and assesses the performance of inflation targeting regimes (ITR). The second reviews the main implications of inflation and examines the theory of inflation undergirding the NMPC. The third considers the potential costs and pitfalls of IT and CBI. The fourth analyses the extent to which this policy framework is applicable to the developing (poor and middle-income) countries. Finally, the fifth section reviews the pro-poor policy framework proposed by UNDP and outlines monetary and anti-inflation policies compatible with pro-poor goals.

Since the early nineties, the NMPC has become the dominant ('best-practice') monetary policy paradigm in several rich and middle-income countries. This consensus is not simply a fad. Its popularity among mainstream economists and policy-makers is based on its theoretical strengths, the alleged successes of countries implementing IT and CBI and, at a deeper level, on the elimination of several shortcomings of the anti-inflation strategies attempted after the collapse of the Bretton Woods System, especially money supply and exchange rate targeting. In this sense, the NMPC offers a well thought-out response to a thirty-year-old riddle: how to anchor domestic monetary systems in the post-Bretton Woods era? The difficulties of stabilising dynamic credit-money economies with bloated financial systems in the absence of exogenous anchors to the value of money cannot be underestimated – but these problems have been resolved in different ways recently. The period of global inflation associated with the collapse of the postwar boom has now ended, and inflation is no longer a serious problem in the

¹ The term NMPC is suggested by Arestis and Sawyer (2005).

vast majority of countries. IT and CBI are one of these possible solutions, and they are informed theoretically by the NMPC.²

The success of this new monetary policy paradigm is not simply the triumph of reasoned academic debate and informed policy-making. It is, to a much greater extent, the outcome of a profound reorganisation of global social relations and the transformation of economic policies in most countries, which is usually called ‘neoliberalism’. The social and political conditions underpinning the implementation of the NMPC cannot be addressed in this paper for reasons of space. This paper is limited in two other ways. First, it does not consider the problem of inflation stabilisation, because IT and CBI are *not* stabilisation strategies – they are appropriate only for countries where inflation has already been subdued. Second, the paper does not offer a detailed first-hand assessment of the performance of ITR in different countries (although it does survey the existing assessments), because this is impossible at this relatively early stage. These are worthwhile objectives, and they should be addressed at a later stage.

The analysis below departs from three key assumptions. First, mass poverty is the most important problem faced by the developing countries, and its elimination should be their governments’ main priority. This aim is not only important in itself; it is also mandated by the United Nations through its Millennium Development Goals (MDGs), determined at the UN Millennium Assembly of September 2000. Second, rapid and sustained growth, balance of payments equilibrium, inflation control, industrial development, and other conventional parameters of economic ‘success’ have no value in themselves. They are, instead, *instruments* for the elimination of mass poverty and the achievement of secure, sustainable, equitable and empowering human development. Third,

² ‘[C]entral banks appear to have learned how to maintain inflation at a low level. For many central banks, this new era has been characterized by central banks adopting implicit or explicit inflation targets’ (Bordo et al 2003, p.1).

macroeconomic policy instruments and, specifically, monetary policy, can contribute to the elimination of mass poverty.

From this pro-poor viewpoint, conventional (mainstream) economic strategies have been largely unsuccessful. The stabilisation and structural adjustment policies implemented in many poor countries during the last twenty-five years have failed to trigger rapid economic growth and the sustained reduction of poverty. Perversely, these policies are not self-correcting, and their perceived failure often leads to the intensification of the ongoing programmes, under even closer supervision by the IMF, the World Bank, the US Treasury Department and most aid agencies:

How to explain that after sustained involvement and many structural adjustment loans, and as many IMF's Stand-bys, African GDP per capita has not budged from its level of 20 years ago? Moreover, in 24 African countries, GDP per capita is less than in 1975, and in 12 countries even below its 1960s level ... How to explain the recurrence of Latin crises, in countries such as Argentina, that months prior to the outbreak of the crisis are being praised as model reformers ... How to explain that the best 'pupils' among the transition countries (Moldova, Georgia, Kyrgyz Republic, Armenia) after setting out in 1991 with no debt at all, and following all the prescriptions of the IFIs, find themselves 10 years later with their GDPs halved and in need of debt-forgiveness? Something is clearly wrong'.³

The introduction of poverty reduction strategy papers (PRSPs) has made no significant difference, and it has become clear that most poor countries –

³ Milanovic (2003, p.679).

especially the poorest sub-Saharan African countries – will *not* achieve their MDGs under the current policy framework.⁴

These limitations of the mainstream development strategy are especially obvious in the field of monetary policy. Since the early nineties, mainstream theory and policy prescriptions have increasingly shifted towards the NMPC, and many developing countries are being pressurised to import this monetary policy framework and to enshrine permanently low inflation among their key policy objectives. This paper argues that this is misguided. The NMPC systematically exaggerates the costs of inflation for the poor, underestimates the output, income and employment costs of locking in very low inflation through IT and CBI, and downplays the economic, social and political consequences of imposing an exceptionally rigid institutional framework for monetary policy.

It is both legitimate and urgent to consider pro-poor monetary policy alternatives for the developing countries, which should be compatible with MDGs and with broader human development targets.⁵ The analysis and recommendations included in this paper build upon previous work of the UNDP, especially through the Asia-Pacific Regional Programme.⁶ This paper does not aim to offer a ready-made set

⁴ '[T]he story of the 1990s can be summarised in three main points. First, progress was made but it was too slow for reaching the agreed targets by 2015. Second, in many cases less progress was made in the 1990s than in the 1970s and 1980s. Third, much of the modest progress by-passed the poor. The countries and the people who most needed to see progress frequently saw the least of it' (Vandemoortele (2004, p.5).

⁵ 'There is universally a greater recognition today of the need to place poverty reduction as the central objective of the process of development. It is, therefore, essential to search for a national development strategy that seeks to achieve human development which is secure, sustainable, equitable and empowering for bulk of the population. Perhaps the most powerful manifestation of a global commitment to poverty reduction is the Millennium Declaration ... The concern for pro-poor policies is the consequence of a deep-rooted disillusionment with the development paradigm which placed exclusive emphasis on the pursuit of growth in many situations, the process of growth was accompanied by rising inequality such that the so-called trickle down effect was either weak or non-existent' (Pasha 2002).

⁶ 'UNDP's approach is to help countries identify the most promising sources of growth and target inequality, both as an impediment to growth and as an obstacle to converting growth into progress against poverty. The recent evidence that inequality inhibits economic growth invalidates the conventional argument that a policy of redistribution will merely lead to sharing poverty, not

of policy alternatives, but it seeks to provide a platform for their development. It is argued below, first, that rapid economic growth is essential for poverty reduction, but growth, inflation control and exchange rate stability should *not* be the main objectives of government policy.⁷ Rather, governments should be able to count on all available instruments – including monetary policy tools – in order to further their pro-poor development strategy.

Second, the combination between growth and equity offers the best opportunity for translating expanded production capabilities into poverty reduction and human development. This combination is policy-driven. Experience shows that the impact of growth on poverty can be highly different depending on the economic, social and political features of the society, and the policies accompanying the process of growth.⁸ It is therefore essential to

forge consistency between the macroeconomic framework and the national poverty reduction strategy. This is usually interpreted as a ‘one-way’ consistency, in which the anti-poverty strategy has to adjust to a fixed and rigid macroeconomic framework. However, both should be jointly determined to serve the overriding objective of poverty reduction.⁹

Third, monetary policy can play an important supporting role in this development strategy, and this paper outlines some of the ways in which this can be achieved. This is not meant to offer a policy blueprint applicable to all countries. This paper

wealth. Equity is good for the poor because it is good for growth as well as for ensuring that its benefits are widely shared among the population’ (UNDP 2002).

⁷ ‘If it can be demonstrated that fast economic growth is always accompanied by rapid poverty reduction, as a result of the ‘trickle-down’ effect, then such strategies can focus, more or less, exclusively on achieving faster growth. However, if this is not necessarily the case, then the pursuit of growth will have to be combined with an effort at achieving more pro-poor growth through a degree of redistribution of assets and incomes in the economy. This would have significant implications on the nature of anti-poverty strategies’ (Pasha and Palanivel 2004, p.1).

⁸ See Pasha and Palanivel (2004, pp.1-2).

⁹ UNDP (2002).

argues that inflation is a socially and historically specific process, and its causes are always very complex and concrete. By necessity, anti-inflation policy is also similarly specific. In spite of this, there are monetary policy lessons to be learned from theory and experience, and general guidelines to be followed within a broader pro-poor policy framework. This research paper aims to contribute to the development of this new analytical and policy approach.

1 – The New Monetary Policy Consensus

The new monetary policy consensus (NMPC) belongs to the family of monetary policy approaches based on nominal anchors. Other members of this family include the gold standard, currency boards and money supply targeting, with which the NMPC has a lot in common (see section 2.1.2). The NMPC evolved gradually, drawing on the insights of the monetarist, new classical and new Keynesian schools of thought.

This section reviews, in four parts, the main features of the NMPC. The first outlines the essential aspects of the consensus, especially IT and CBI. The second explains the anti-inflation policies associated with the consensus. The third reviews the advantages of the NMPC vis-à-vis its mainstream predecessors, and the fourth assesses the performance of inflation targeting countries.

1.1 – The Consensus

This section briefly summarises the theoretical underpinnings of the NMPC. The new consensus departs from four basic propositions, discussed below, concerning the costs of inflation, the scope for monetary policy, IT and CBI.¹

1.1.1 – The Costs of Inflation

The NMPC claims that inflation is costly and that high or variable inflation can be very costly. Inflation distorts the tax system, exacerbates price volatility and reduces the transparency of the relative prices,² increases the riskiness of nominal

¹ See, *inter alia*, Agénor (2001), Arestis and Sawyer (2005, forthcoming) and Mishkin (2004).

² Meyer (2001) offers the following definitions of price stability, drawing on Paul Volcker and Alan Greenspan: ‘A workable definition of reasonable “price stability” would seem ... to be a situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behavior. Stated more positively, “stability” would imply that decisionmaking should be able to proceed on the basis that “real” and “nominal”

contracts and contributes to malinvestment and resource misallocation.³ It also taxes money-holders arbitrarily and regressively, because the poor tend to hold a larger proportion of their assets as cash, and they are less able than the rich are to avoid paying the inflation tax. Inflation also leads to demonetisation, lower savings, lower financial system depth and efficiency, and it stimulates capital flight into foreign assets, precious metals, or unproductive real estate. These costs and inefficiencies imply that economies experiencing high or variable inflation over long periods will tend to perform poorly, and they may even face social and political unrest. Conversely, price stability reduces economic costs, increases the efficiency of the price system, and it can help the economy achieve higher long-term GDP growth rates.

1.1.2 – The Real-Monetary Dichotomy

There is a real-monetary dichotomy in the economy. The first implication of this dichotomy is that the long-run Phillips curve is vertical. In other words, there is no long-run trade-off between nominal variables, such as inflation, and real variables such as output, output growth or unemployment. There may be short-run trade-offs between them, and monetary policy can influence real variables transitorily. However, it cannot fine-tune the level of output or employment because its short and medium-term impact on the real variables is mediated by unpredictable lags. In the long-term, as was explained above, monetary policy is neutral: the economy will supposedly adjust to the natural rate of unemployment, the NAIRU, or the equivalent rate in other models at any inflation rate. Since inflation has significant

values are substantially the same over the planning horizon – and that planning horizons should be suitably long’ (Volcker), or ‘We will be at price stability when households and businesses need not factor expectations of changes in the average level of prices into their decisions’ (Greenspan).

³ See, for example, Agénor (2001), Bernanke and Mishkin (1997, pp.106, 109) and Fischer, Sahay and Végh (2002, p.876-7).

costs (as was shown in section 1.1.1) but brings no long-term benefits, inflation control is an important economic policy objective:

[I]f one believes that, in the long-run, there is no trade-off between inflation and output then there is no point in using monetary policy to target output You only have to adhere to] the view that printing money cannot raise long-run productivity growth, in order to believe that inflation rather than output is the only sensible objective of monetary policy in the long-run.⁴

The second implication of the real-monetary dichotomy is that, in the long-run, inflation is determined by excess money supply:

Few economists would disagree that inflation is, as Milton Friedman taught us long ago, always and everywhere a monetary phenomenon ... [M]onetary policy ... determines the rate of inflation in the long-run. While ... supply shocks – such as abrupt changes in the price of energy or food unrelated to the overall balance between aggregate demand and supply – can result in short-run changes in inflation, such changes in inflation can persist only if central banks accommodate them. Central banks therefore must accept full responsibility for inflation in the long-run and have the tools to achieve price stability.⁵

Presumably, adverse supply shocks or rigidities, terms of trade shifts, distributive conflicts and changes in expectations have only a limited impact on inflation.

⁴ Mervyn King, current Governor of the Bank of England, cited in Arestis and Sawyer (2005). Fed Governor Laurence Meyer (2001) similarly claims that ‘monetary policy ... cannot affect the level of output or its growth rate in the long-run, other than by maintaining low and stable inflation. Therefore, the objective of price stability should be assigned to monetary policymakers, but the objective of high and rising living standards should not be’. See also Agénor (2001, p.3) and Mishkin (1998, p.1).

⁵ Meyer (2001).

They either fade away gradually or cancel each other out over time. In contrast, monetary control is essential at all times in order to avoid persistent inflation.

It is difficult to deliver monetary control because of the *inflation bias* due to the time-inconsistency problem: myopic policy-makers have an incentive to misuse the short-term power of monetary policy to inflate the economy for crass electoral reasons even though this is ultimately destabilising and inflationary (the political business cycle).⁶ The ‘rational political business cycle’ offers a variation of this argument, suggesting that an inflation bias may arise as the rational response of the private agents to uncertainty as to *future* government policy, or their belief that the government may artificially inflate the economy at some point. Once this possibility has been factored into their inflation expectations there will be inflation even though government policy has not actually changed (yet).⁷ Milton Friedman famously proposed his fixed money supply growth rule (money supply targeting) in order to limit the politicians’ access to monetary policy instruments and remove this inflation bias. *Nominal anchors* such as money supply targeting discipline the behaviour of the central bank and, indirectly, the politicians, helping to remove the inflation bias from the economy.⁸

In sum, price stability is the most important contribution that monetary policy can give to social welfare. Attempts to use monetary policy to achieve other goals, such as higher output or employment, may conflict with price stability and can introduce a persistent inflationary bias in the economy.

⁶ See Gärtner (2000, p.529).

⁷ See Forder (2003, p.22) and Mayes (1998, p.8).

⁸ ‘A nominal anchor is a publicly announced nominal variable that serves as a target for monetary policy. A nominal anchor fosters price stability by constraining the value of money and thereby tying down inflation expectations. The potential nominal anchor choices encompasses those based on convertibility into a commodity, generally specie, such as gold or silver; the currency of another country; a common currency in a currency union; a monetary target, an exchange rate target, and an inflation target’ (Stone and Bhundia 2004, p.5). See also Mishkin (1998, p.1).

1.1.3 – Inflation Targeting

The government should signal its ‘explicit acknowledgement that low and stable inflation is the overriding goal of monetary policy’⁹ by setting a legally binding numerical inflation target (IT), that should be pursued by an independent central bank (see section 1.1.4).¹⁰ The IT can be either an interval or a point, and it may include tolerance margins (see section 1.3.1). The IT should be the *only* nominal anchor in the economy, as it cannot be pursued simultaneously with money supply, wages, employment or exchange rate targets (see section 3.3).¹¹

The inflation targeting regime (ITR) operates at multiple levels.¹² At the level of government, it institutionalises ‘good’ (i.e., conservative, see section 1.1.4) monetary policies, increases the transparency and accountability of central bank actions, and provides guidelines for other policies, especially fiscal, employment and exchange rate policies. From the point of view of the private sector, ITR offers clear objectives for government policy (in this sense, it operates like exchange rate targeting regimes, and in sharp contrast with money supply targeting systems). ITR also provides a trend for the inflation expectations and indications about future government policies. This will reduce uncertainty and facilitate economic planning and co-ordination across markets, lowering the adjustment costs and assisting the consolidation of the new, low inflation

⁹ Bernanke and Mishkin (1997, p.97).

¹⁰ ‘The hallmark of inflation targeting is the announcement by the government, the central bank, or some combination of the two that in the future the central bank will strive to hold inflation at or near some numerically specified level’ (Bernanke and Mishkin 1997, p.98).

¹¹ See Debelle et al (1998).

¹² The preconditions for this policy regime are explained by Eichengreen (2002, p.7).

regime.¹³ If it is implemented competently, ITR can be highly successful – it can even ‘deliver as much price level stability as a commodity [gold] standard’.¹⁴

The transition costs to the new policy regime, which are measured by the extent and duration of any fluctuation of the level of output, are usually low. They depend largely on the credibility of the government’s commitment to the ITR and the reputation of the central bank.¹⁵ The more credible the government’s commitment and the better the central bank’s reputation, the faster the expectations will converge to the IT and the lower the output costs of reducing inflation (the ‘sacrifice ratio’). Hence, ‘imperfect credibility may require the central bank to target inflation [more] rigidly’,¹⁶ implying that there is a transitory trade-off between credibility and flexibility. In the short-term, making the regime credible requires the authorities to abdicate from short-term flexibility and policy discretion. However, in the long-term, having acquired credibility the authorities will have more scope to be flexible.¹⁷ Once established, ITR will bring other benefits in addition to policy flexibility. They include lower and more stable inflation, higher economic growth rates, and a permanently lower sacrifice ratio.¹⁸ These potential benefits suggest that other government policy objectives – such as

¹³ [T]he credible commitment of the monetary authority to a numerical target may also contribute to better coordination among agents and markets. For example, announcing inflation targets may reduce the reaction of agents to inflation news or the dependence of specific prices on formal or informal indexation mechanisms, aligning expectations closer to central bank actions’ (Landerretche et al 2001, pp.7-8). See also Gavin (2003) and Meyer (2001).

¹⁴ Bordo et al (2003, p.1).

¹⁵ ‘Monetary policy works both through the setting of a target short-term nominal interest rate and by the expectations policymakers induce in the markets, wittingly or unwittingly, about the course of future policy. To the extent that market participants correctly anticipate future policy moves, long-term interest rates will move in response to expectations of future moves in short-term rates, in effect, speeding the response of aggregate demand to monetary policy’ (Meyer 2001).

¹⁶ Eichengreen (2002, p.36); see also Agénor (2001, p.59). In other words, *credibility* is determined *ex ante*, by the perceived commitment of the central bank to the new policy regime. *Reputation* is established *ex post*, on the basis of the bank’s performance.

¹⁷ Debelle et al (1998); see also Agénor (2001, pp.3, 21-2, 26, 62-3), Bogdanski et al (2000, p.5) and Mishkin (1998, p.27).

¹⁸ See Fontana and Palácio-Vera (2002). The sacrifice ratio is usually computed as the ratio of the sum of deviations of potential from actual output, divided by the decline in inflation (Landerretche et al 2001, p.6n6).

employment generation, economic growth and income distribution – should be subordinated to the IT (see section 1.3.4):

A mandate to pursue an inflation target, a reasonable degree of instrument independence, and public accountability make up the first set of initial conditions for adopting inflation targeting. Other objectives, such as wage rates, the level of employment, or the exchange rate must be subordinated to the inflation objective.¹⁹

In contrast with money supply or exchange rate targeting regimes, under ITR the central bank does not make policy decisions based on current developments, past data or arbitrary assumptions. The long lags in the monetary policy transmission process imply that bank policies must be guided by *future trends*, especially inflation forecasts conditional on the probable development of the exogenous variables (see section 1.2). In doing this, the central bank will respond to inflationary pressures before they have become embedded in the agents' expectations and in the wage and price setting processes, which would increase the costs of stabilisation. In this sense, this policy regime may usefully be called *inflation forecast targeting*.

The important role of future developments for this policy regime supposedly makes monetary policy transparency and central bank accountability essential for inflation targeting. Transparency (or openness) and accountability concern the clarity of the central bank's commitment to the IT, and its regular assessment of government policy and its likely consequences for inflation. This includes, for example, the publication of periodic *Inflation Reports* setting out the central bank's analysis of recent developments and its inflation forecasts, regular statements to Parliament, press briefings, and so on. Transparency and accountability allow the economic agents to assess whether deviations from the IT

¹⁹ Carare et al (2002, p.5).

or policy adjustments are due to random shocks, policy blunders or, more worryingly, lack of commitment to the announced policies. Increased transparency and accountability reduce the lag between monetary policy changes and their effects on prices and wages, increasing their effectiveness.²⁰

In spite of its advantages, IT is not always appropriate for all countries and circumstances (see section 4). In particular, five conditions should be satisfied in order to make this policy regime viable. First, the monetary authorities should have effective policy tools and autonomy to deploy them (see section 1.1.4). Second, the absence of fiscal dominance; in other words, fiscal policy considerations cannot play a determining role in macroeconomic policy decisions.²¹ This requires that government borrowing from the central bank should be strictly limited, and that public sector funding should rely on a broad tax base and an efficient tax system, rather than on seignorage. Third, the rate of inflation should be low enough at the start to ensure a reasonable degree of monetary stability and central bank control (in other words, IT is *not* a stabilisation policy; see section 1.4.3).²² Fourth, the financial market needs to be sufficiently developed, deep and efficient to absorb placements of public debt, such as treasury bills or bonds, and to avoid financial instability, which could side-track monetary policy.²³ Fifth, absence of external dominance, in other words, the country's balance of payments should be sufficiently strong to allow monetary policy to focus on inflation control in the face of adverse external shocks (see sections 3.3 and 4.2).

²⁰ See Debelle et al (1998).

²¹ See Agénor (2001, p.22-3).

²² See Carare et al (2002, p.13).

²³ '[A] safe and sound financial system is ... a necessary condition for the success of an inflation targeting regime. A weak banking system is particularly dangerous. Once a banking system is in a weakened state, a central bank cannot raise interest rates to sustain the inflation target because this will likely lead to a collapse of the financial system. Not only can this cause a breakdown of the inflation targeting regime directly, but it can also lead to a currency collapse and a financial crisis that also erode the control of inflation' (Mishkin 2004, pp.6-7). See also Carare et al (2002, p.4).

These are not straightforward requirements. On the one hand, a country may move towards ITR even if not all elements of the package are in place, since the increased economic stability and the enhanced credibility of the government's policies will help to create the conditions for the further success of ITR. On the other hand, however, the initially low credibility of the new policy regime – especially in countries historically plagued by high inflation, economic instability and weak institutions, implies that exceptionally tight monetary policies will be required at the beginning. This will negatively affect the fiscal balance and, potentially, financial stability. However, in time, the economy will adjust to the new regime and monetary policy can be relaxed without any loss of control over inflation (see above).²⁴

²⁴ See Fraga et al (2003, p.23).

1.1.4 – Central Bank Independence

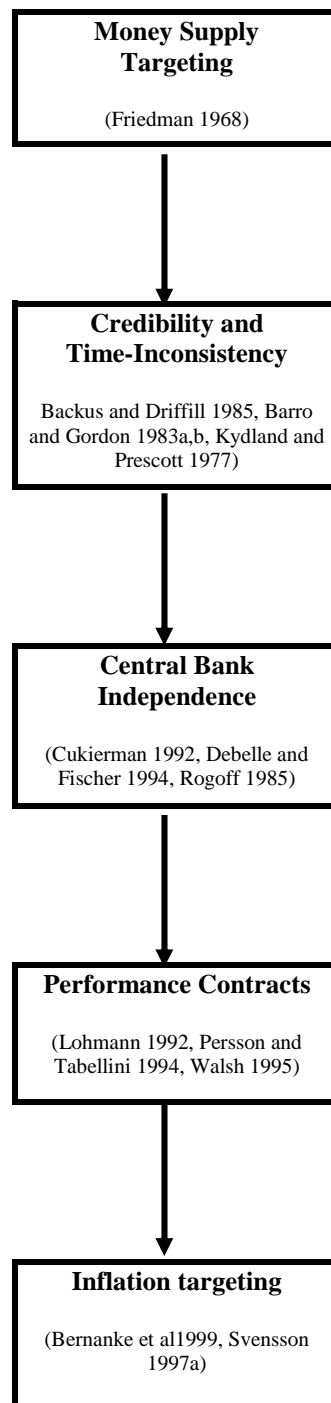
In the NMPC, CBI is essential for inflation targeting. Perceptions of the role of the central bank in anti-inflation programmes have changed significantly over time (see Figure 1, which is also included in Appendix A). The first generation of models of CBI draws on Friedman’s (1968) proposal of money supply targeting and on the pioneering work of Kydland and Prescott (1977), who argued that monetary policy ‘rules’ lead to higher levels of social welfare than ‘discretion’.²⁵ Rogoff (1985) developed their work, and claimed that if the social loss function includes both deviations of inflation and output from their optimal levels, losses could be minimised if monetary policy is guided by a conservative central banker (the banker’s preferences remain unexplained in this model, but see section 3.6).²⁶ A ‘conservative’ central banker places a higher weight on inflation stabilisation in her/his objective function than society as a whole (i.e., the representative government), although s/he is not necessarily unconcerned with unemployment. The central banker’s preferences and reputation create a tendency towards disinflation that will partly compensate for the inflation bias identified by Kydland and Prescott.

These first-generation models imply that CBI can help to reduce the rate of inflation because it insulates monetary policy from the political prices. This minimises the time-inconsistency problem created by political pressures to explore the short-run Phillips curve through overly expansionary monetary policy.

²⁵ ‘Arguably, the most important result in political macroeconomics has been that democratic governments, or central banks with representative preferences, tend to generate inefficiently high inflation rates, without the benefit of reaping lasting output gains beyond potential output. While this *inflation bias* was initially rationalized in the context of deterministic models ... much of the recent discussion surrounding this issue makes sense only in a stochastic framework. Only there does the possibility of a conflict arise between a reduction in the inflation bias on the one hand and optimal stabilization, i.e. the right intensity of the policymaker’s response to supply shocks, on the other hand’ (Gärtner 2000, p.528). See also Forder (n.d.) and Mendonça (2002).

²⁶ For a critique, see Lapavistas (1997).

Figure 1: Models of Central Bank Independence and Inflation Targeting



Given CBI, the appointment of a conservative central banker whose preferences are more inflation averse than the government's functions as a commitment device that helps to maintain lower inflation rates than would otherwise be possible.²⁷ However, the cost of low inflation is increased output instability – in fact, the more conservative is monetary policy the smaller the variance of inflation, but the higher is the variance of output.²⁸

The assumption that the central bank is primarily responsible for achieving price stability is the point of departure of the second generation of models of CBI. Given the limitations of Rogoff's conservative central banker, the key problem becomes the institutional framework that is most conducive to the elimination of the inflation bias. Drawing on principal-agent theory, Walsh (1995) suggested that optimal contracts could be drawn for the central bankers, penalising them if inflation deviates from the target set by the government. This approach is supposedly compatible with political democracy, because the central bank will attempt to pursue the government's objective of inflation minimisation regardless of any differences between the bank and the government's objective functions, or the existence of information asymmetries.

The third generation of models combines the arguments developed previously. These models claim that CBI and IT are the most credible, reliable and lowest-cost institutional arrangements for addressing the time-inconsistency problem. Typically, Svensson (1997a) grants autonomy to a central bank that is held responsible for the achievement of a given IT. Svensson rejects the idea of performance contracts for the central bankers because of practical difficulties (e.g., it would be politically unpalatable to reward the central bankers financially for achieving low inflation at the expense of exceptionally high unemployment).

²⁷ See Alesina and Summers (1993, pp.151-2) and Gärtner (2000, pp.528-30).

²⁸ See Gärtner (2000, p.532). Barro and Gordon (1983a,b) and Backus and Driffill (1985) draw even more extreme conclusions from the work of Kydland and Prescott, pointing out that there would be advantages in the central banker being extremely inflation-averse; see Forder (n.d.).

However, Svensson also shows that the IT can effectively mimic the optimal incentive contracts, so there is no macroeconomic performance loss.²⁹ This generation of models implies that the choice between inflation and output stabilisation depends on the parameters of the problem at hand, especially how often shocks occur and how big they are. If shocks are rare, the conservative central banker tends to dominate a representative government; otherwise, the choice of a more liberal central banker could become optimal.³⁰

The distinguishing features of CBI are the institutionalisation of the primary responsibility of the central bank for achieving the IT, the appointment of its directors for fixed terms (preferably not coinciding with the mandate of the country's president or the legislators, in order to ensure policy continuity), and the regular assessment of the bank's performance through the trajectory of inflation and the bank's reports to the government, the legislature and the media.³¹ At a more specific level, the institutional arrangements underpinning CBI may vary between countries and over time. These potential differences may include the precise duties of the bank, the policy instruments that it controls, its degree of administrative autonomy, the institutional relationship between the central bank and other government departments, the procedure for appointing bank directors and the limits on government borrowing from the bank.³² In spite of their practical

²⁹ See Agénor (2001, p.24), Gärtner (2000, p.537) and Mishkin (1998, p.19).

³⁰ See Gärtner (2000, p.531).

³¹ 'Few economists would disagree that inflation is, as Milton Friedman taught us long ago, always and everywhere a monetary phenomenon. This was earlier interpreted as a statement about a tight relationship between money growth (controlled by the central bank) and inflation. Today, it is recognized that even if the relationship between money growth and inflation has weakened, perhaps because of financial innovations, central banks can achieve their inflation targets by adjusting their preferred instrument, typically some short-term interest rate. Hence, monetary policy still determines the rate of inflation in the long-run. While it is also well understood that supply shocks – such as abrupt changes in the price of energy or food unrelated to the overall balance between aggregate demand and supply – can result in short-run changes in inflation, such changes in inflation can persist only if central banks accommodate them. Central banks therefore must accept full responsibility for inflation in the long-run and have the tools to achieve price stability' (Meyer 2001).

³² See Grilli et al (1991); see also Arestis and Sawyer (1998a).

significance these details will be ignored in what follows, in order to permit a general assessment of the NMPC.

Presumably, CBI would limit the influence of the politicians over economic policy-making, greatly reducing or eliminating uncertainty, time-inconsistency, the political business cycle and the inflation bias. In this sense, CBI could improve economic performance.³³ Even though it limits the power of the politicians, CBI is allegedly not inimical to democracy because the central bank regularly reports to Parliament and the public. At a further remove, the bank's performance is assessed continually through the credibility of the ITR, the public's expectations, and the trajectory of inflation – the bank's independence does not create a 'democratic deficit'.

Finally, the central bank must be technically competent (informed by mainstream economic theory and run by experts, presumably mainstream economists, financiers or trusted civil servants, see section 3.6), and it must be able to select the appropriate policy instruments and conduct monetary policy autonomously.³⁴ In other words, in addition to political (administrative) independence the central bank also needs to have *instrument independence*.³⁵ In contrast, goal independence (the central bank's ability to select the appropriate goals for monetary policy) is usually frowned upon, because it is perceived to be undemocratic (see section 3.5).³⁶

³³ See Forder (2003, p.22)

³⁴ 'Inflation targeting requires that the central bank be endowed by the political authorities with a clear mandate to pursue the objective of price stability and most importantly a large degree of independence in the conduct of monetary policy—namely, in choosing the instruments necessary to achieve the target rate of inflation. This implies, in particular, the ability to resist political pressures to stimulate the economy in the short-term' (Agénor 2001, p.22-3).

³⁵ 'Instrument independence means that the central bank is prohibited from funding government deficits, has to be allowed to set the monetary policy instruments without interference from the government and the members of the monetary policy board must be insulated from the political process by giving them long-term appointments and protection from arbitrary dismissal' (Mishkin 2004, p.12).

³⁶ 'Instrument independence would seem to be the form of independence that maximizes central bank accountability and minimises opportunistic political interference, while still leaving the

1.2 – NMPC Policies

The economic model underpinning the NMPC is essentially very simple (see Figure 2 and Appendix A).³⁷ It includes two key parameters, the IT and the inflation expectations; the former is set by the government and the latter by the private sector. The model also includes one discretionary policy instrument, the nominal interest rate.

The government policy objective is to eliminate the inflation gap, or the difference between the rate of inflation and the IT at some point in the future (the policy horizon; see section 1.3.2).³⁸ The model presumes that inflation is jointly determined by the inflation expectations and the output gap, with the latter fluctuating around a supply-side equilibrium. Alternatively, the rate of unemployment fluctuates around the natural rate or the NAIRU, such that unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation.³⁹ The output gap (the difference between the rate of unemployment and the natural rate, or the NAIRU) is determined by the real interest rates. Finally, the real interest rates are, by definition, equal to the nominal interest rates minus the inflation expectations.

In this essentially new Keynesian model the central bank attempts to hit the IT through the manipulation of the nominal interest rates in order to influence the state of expectations immediately and, at a further remove, fine tune the level of

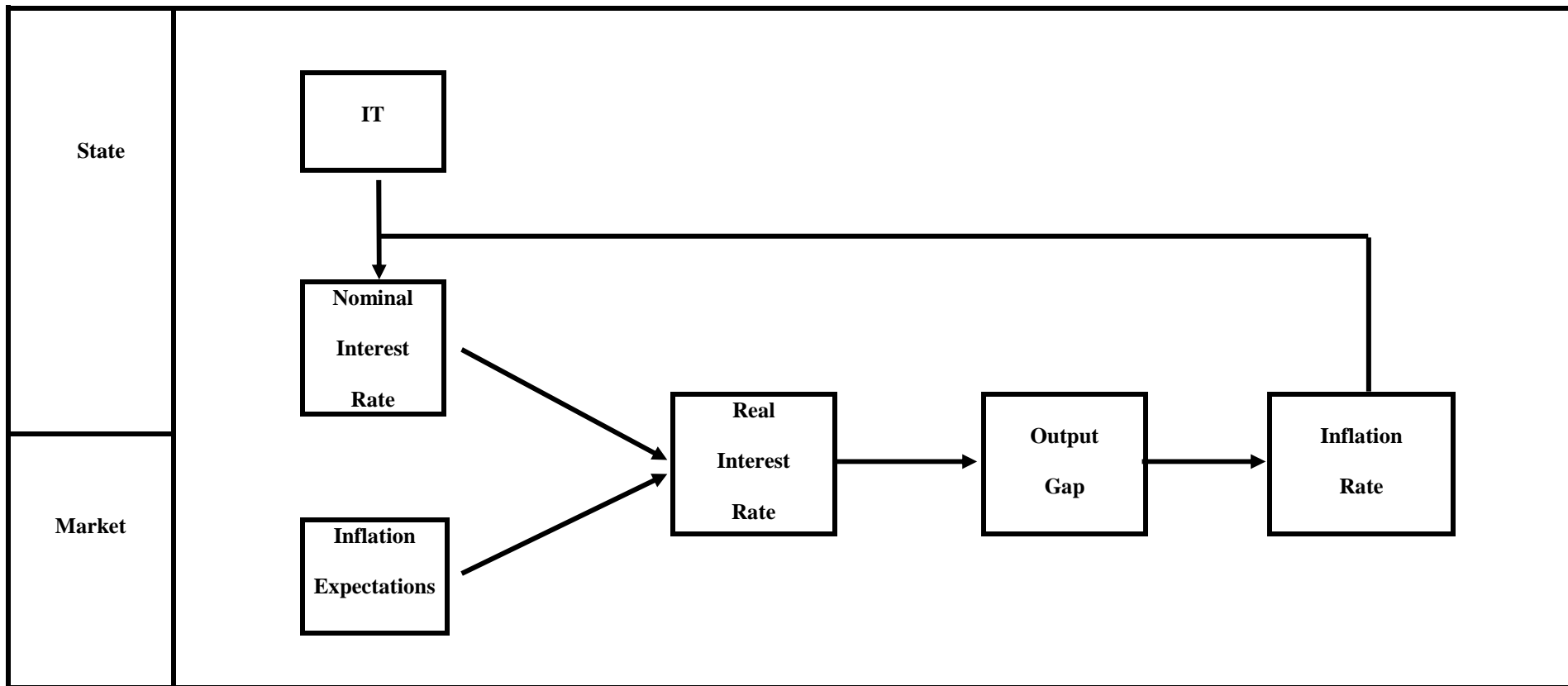
ultimate goals of policy to be determined by democratic processes' (Bernanke and Mishkin 1997, p.102n8).

³⁷ See Agénor (2001, pp.5-7), Arestis and Sawyer (2005) and Eichengreen (2002, pp.10-11).

³⁸ See Agénor (2001, p.10).

³⁹ See Arestis and Sawyer (2005).

Figure 2: Inflation Control in the NMPC



aggregate demand.¹ If the central bank forecasts a positive inflation gap during the policy horizon, either because aggregate demand is too high or because the market expects that inflation will rise in the future for whatever reason, the central bank will adjust monetary policy, usually by raising nominal (and, *ceteris paribus*, real) interest rates.²

Higher interest rates will depress demand and raise the output gap through many different channels. They will revalue the exchange rate, immediately lowering imports prices; raise the cost of borrowing, dampening investment and durables consumption; reduce wealth and consumption; cut corporate net worth, investment and bank lending, and lead highly leveraged firms to bankruptcy, worsening the expectations of economic activity. The rate of inflation will eventually decline through a combination of these pressures.³ Conversely, if the inflation gap is negative or if the expected rate of inflation is too low the central bank will lower nominal interest rates. The output gap will fall and inflation will rise, again converging to the target.

The model implies that inflation control is achieved at the expense of fluctuations in the output gap. The lower is the government's tolerance to an inflation gap, the shorter is the time-span available to achieve IT, and the more open the economy the larger will be the fluctuations of the output gap and, therefore, the variance of the unemployment rate (see sections 1.1.4, 2.2 and 3.1).⁴

¹ See Minella (2002) and Roberts (1995).

² The bank's procedure follows an appropriate instrument rule, which is a formula for setting the central bank's instrument rate as a given function of a small number of observable variables. The best-known example is the Taylor rule, where the instrument rate is a linear function of the inflation gap and the output gap. See Dennis (2001, p.105) and Svensson (2004, p.1).

³ See Carare et al (2002, p.19).

⁴ '[I]f the central bank, in addition to seeking to achieve its inflation target, aims at stabilizing output, it should allow for a slower adjustment of the inflation forecast to the target value compared to a situation in which the inflation target is the only goal. Extension of the analysis to an open-economy setting showed that, given the critical role that the exchange rate plays in the transmission process of monetary policy, inflation targeting may lead to a relatively high degree of output volatility by inducing excessive fluctuations in interest rates' (Agénor 2001, p.63).

Finally, although a wide variety of instruments can be used in order to achieve IT, in practice central banks tend to focus primarily on the manipulation of the nominal interest rates.⁵ This instrument is especially convenient because it is simple to use; it is also supposedly non-distortionary, because changes in the base rates do not systematically discriminate between different sectors of the economy and, therefore, do not lead to resource misallocation.

1.3 – Anchors and Flexibility

In contrast with such policy regimes as money supply or exchange rate targeting, the NMPC is flexible at four levels.

1.3.1 – Low but Positive Inflation Targets

The IT is normally low and positive, rather than zero, and the targets are usually bands, rather than points (see section 1.4). Bands are used for three reasons. First, because of the possibility of misspecification, parameter uncertainty or structural breaks in the central bank economic model. Second, because of the uncertainty surrounding the monetary transmission process and the links between the policy levers and the inflation outcomes. Third, because of the regular occurrence of shocks (see section 1.3.2).⁶ This would make it very difficult to hit continuously a single point target for inflation, and even trying to do so would cause interest rates to be highly volatile, which would be destabilising. Targeting bands rather than points also provides a measure of flexibility for the central bank, because it can enjoy some discretion over which point in the band it aims for in taking its policy decisions allowing it to accommodate transitory shocks more easily. However, bands create a trade-off between credibility and flexibility, because the wider the bands the more likely it is that they will be hit, but the less credible the target will

⁵ See Bogdanski et al (2000, p.8) and Bordo et al (2003, p.23). In particular, fiscal policy is perceived to be given in the short-term because of the delays and uncertainties involved in its use.

⁶ See Minella et al (2002, p.35).

be.⁷ Their size also gives an indication of the limits of the central bank's forecasting model, and the trade-off between inflation and output variance in the bank's objective function, with tighter bands signalling a preference for lower inflation volatility relative to output volatility.⁸

The preference for low rather than zero inflation can be explained at three levels. First, the price indices usually overstate the rate of inflation, so even if the government aims to eliminate inflation its target should be a small positive number.⁹ Second, if nominal wages are rigid downward zero inflation would reduce the flexibility of real wages and worsen the allocative efficiency of the labour markets, increasing the natural rate of unemployment. Third, zero inflation would increase the risk of the economy tipping into deflation (see section 4.5). A small but positive IT helps to avoid this risk, because the targets provide not only a ceiling, but also a floor for the rate of inflation.

1.3.2 – Tolerance to Deviations

In currency boards or exchange rate targeting regimes it is impossible to depart temporarily from the peg or target band without a severe loss of credibility and possibly a currency crisis. In contrast, in ITR the central bank does not aim to reach the IT either continually or inflexibly.¹⁰ The bank normally targets inflation over a policy (target) horizon of one to three years in the future because of the delays of the monetary policy transmission mechanism,¹¹ and to avoid having to respond to transitory price disturbances that would not normally trigger long-term variations of the rate of inflation. A very short policy horizon would require returning inflation to the target too rapidly following some departure, which could

⁷ See Agénor (2001, p.33-5).

⁸ See Fraga et al (2003, p.30) and Minella et al (2002, p.39).

⁹ See Bernanke and Mishkin (1997, p.110).

¹⁰ See Agénor (2001, pp.21-2) and Eichengreen (2002, p.7).

¹¹ In other words, the target horizon cannot be shorter than the control horizon (Agénor 2001, p.35).

result in excessive variability of output. The policy horizon may even be lengthened or the targets changed if the economy faces relatively large adverse shocks, in order to avoid drastic interest rate adjustments.¹²

In order to make the system even more robust, the rate of inflation is usually measured by a ‘core’ (rather than headline) price index, usually the CPI, in order to exclude the direct impact of price disturbances that should not be allowed to influence monetary policy.¹³ These disturbances include adverse supply shocks, natural disasters, sudden fluctuations in the exchange rate or the terms of trade, seasonal variations of food and energy prices, changes in indirect taxes, regulated prices, subsidies and mortgage payments, and even the direct (first-round) impact of interest rate changes (which may trigger a ‘spurious’ rise in inflation).¹⁴ In cases such as these, a strong monetary policy response could produce very large fluctuations in the real economy for no significant long-term gain in terms of inflation control. Finally, if the economy is especially prone to shocks the bands should be wider and the central target should be higher, in order to increase the probability of fulfilment with acceptable output costs.¹⁵

A failure to hit the original targets continually should not endanger the ITR for, although there may be an initial credibility loss due to the change in the targets or

¹² ‘[T]he bands should be treated mainly as a communications device. The bands should be considered mainly as checkpoints, with the central bank explaining clearly the reasons for the [occasional] nonfulfillment of the targets’ (Fraga et al 2003, p.30). See also Agénor (2001, pp.14-15) and Bernanke and Mishkin (1997, p.101).

¹³ See Arestis, Caporale and Cipollini (2002, p.531) and Carare et al (2002, pp.28-9).

¹⁴ ‘The main argument contrary to the use of [a] core inflation [index] is that it is less representative of the loss of the purchasing power of money, at a given point in time ... [However,] there are two advantages ... First, the core inflation measure is not necessarily isolated from the effect of shocks ... the construction of the adjusted target is directly based on the idea that monetary policy should neutralize second-order effects of supply shocks and accommodate the first-round effects, and on the fact that some weight to output volatility should be assigned in the [central bank’s] objective function ... The main advantages of the adjusted target procedure are the following: i) it is a forward looking procedure, ii) it defines clearly the new target to be pursued by the central bank, and iii) it explains how the new target is measured’ (Fraga et al 2003, pp.37-8). See also Agénor (2001, p.31), Bernanke and Mishkin (1997, pp.101, 109), Meyer (2001) and Mishkin (1998, p.20).

¹⁵ See Agénor (2001, p.13) and Fraga et al (2003, p.31).

the policy horizon, there will be a subsequent gain if the central bank is transparent about its ultimate objective and the policies being implemented to reach it. In fact, sticking to an unrealistically low target would be *more* damaging to the credibility of the ITR, since the private agents would rapidly realise the pointlessness of the exercise and would lose confidence in the central bank's statements about the effectiveness of its policies.¹⁶

1.3.3 – Instrument Flexibility

Although interest rate manipulation (and the corresponding open market operations) is clearly the favoured monetary policy instrument under ITR, the central bank should employ all relevant information and a wide variety of tools in order to pursue the IT. These tools depend on the institutional structure of the central bank, the country's political system and the policy-maker's conviction about how best to operate in the circumstances. They could include, for example, changes in the banking regulations or the required reserve ratios, the imposition of differential asset requirements, and so on, as long as they contribute to the achievement of the IT within the policy horizon.

By potentially accommodating widely different policies, ITR is a flexible policy framework that grants the central bank discretion to respond to specific challenges within a clear commitment to achieve price stability. This is called 'constrained discretion', and it presumably offers a middle ground between inflexible rules and unfettered discretion.¹⁷

¹⁶ See Fraga et al (2003, p.33). Note, however, that 'flexibility can be destabilizing when credibility is lacking' (Eichengreen 2002, p.40).

¹⁷ Arestis and Sawyer (2005); see also Agénor (2001, p.65) and Bernanke and Mishkin (1997, p.101).

1.3.4 – Hierarchical and Dual Mandates

Many proponents of the NMPC argue that monetary policy should be sufficiently flexible to incorporate the secondary objective of minimising output fluctuations, as long as this does not detract from the IT in the long-run.¹⁸ This is called a ‘dual mandate’, or ‘flexible inflation targeting’, in contrast with the stricter ‘hierarchical mandate’ where all policy objectives are subordinated to the inflation target:

[M]onetary policymakers should be concerned about *two* long-run properties of the economy. One is price stability and the other is the variability of output around full employment. Policy has to be judged by its success in both dimensions ... [Moreover,] policy is made in the short-run, not the long-run. The speed of return of output to its potential level is influenced by policy decisions and cannot be treated with indifference. It may just take too long and waste too many resources in the interim to rely on the self-equilibrating forces of the economy. Policymakers will therefore have to take into account, in practice, both objectives in their policy actions ... [Bank of England Governor] Mervyn King calls regimes which take no account of output gaps (where the coefficient on the output gap is zero in the loss function) “inflation nutters.” That language suggests that entirely ignoring output stabilization is now viewed as an extreme position and not as a desirable option for central banks. Lars Svensson argues that there has, in fact, been a convergence toward “flexible inflation targeting” – meaning inflation-targeting regimes that in practice take into account deviations in both output and inflation from their respective targets. Such an evolution has brought many inflation-targeting regimes closer in practice to a dual mandate regime.¹⁹

¹⁸ See Eichengreen (2002, p.8), Meyer (2001) and Mishkin (1998, p.26).

¹⁹ Meyer (2001).

Although the dual mandate is a step in the right direction (see section 3.5), it remains strictly limited. Its proponents claim that monetary policy is *sufficient* to control inflation, that inflation control is *essential* for welfare maximisation, and that the central bank is the *main* institution responsible for achieving IT. In practice, the dual mandate means only that the inflation target will be achieved over a somewhat longer horizon.²⁰ Moreover, even if there is scope for output stabilisation, growth maximisation and the minimisation of output volatility under the dual mandate, these objectives necessarily involve several government institutions and agencies. It is never argued that the central bank has any special power to deliver these outcomes, or that it should have targets or obligations in this respect. In other words, the dual mandate offers only a bit more flexibility in the process of achieving low inflation, rather than a fundamentally different (i.e., more expansionary) economic policy (see section 3.4).

1.3.5 – Summing Up

The NMPC is the culmination of several years of mainstream research, and it reflects the accumulated experience of decades of monetary policy-making. It has broad theoretical foundations, including insights from the monetarist, new classical and new Keynesian schools of thought. It explains what monetary policy can and cannot achieve, identifies the adequate policy targets and the most efficient instruments to achieve them, and specifies the institutional framework in which these instruments may be deployed successfully. The NMPC also offers concrete suggestions for the elimination of the inflation bias and the dynamic time-inconsistency problem: while CBI insulates monetary policy from short-run political considerations, IT ensures that the goals of monetary policy cannot diverge from the ultimate interests of society for extended periods.²¹

²⁰ See Fraga et al (2003, p.31).

²¹ Mishkin (1998, p.24).

This policy regime offers several advantages vis-à-vis alternative nominal anchors. For example, in contrast with exchange-rate targeting inflation targeting allows monetary policy to focus on domestic considerations and to respond to shocks to the domestic economy. In contrast with money supply targeting ITR is a robust policy regime, that is immune to velocity changes or shifts in the relationship between the intermediate targets (money supply growth) and the policy goals (low and stable inflation).²²

The advantages and the internal consistency of the NMPC increase the credibility of monetary policy and the accountability of the authorities. This will help the convergence of the inflation expectations toward IT, and reduce the sacrifice ratio and the inflationary impact of adverse shocks. Credibility and accountability will also help the central bank to deliver increased economic stability and efficiency, as well as faster output and employment growth in the long-run, with considerable benefits for the poor. In sum, the NMPC claims to offer the optimal combination of instruments to lock in low inflation and create the essential conditions for sustainable and equitable growth, including policy simplicity, credibility, legitimacy, sustainability and flexibility. Claims such as these have contributed to the rapid growth of the appeal of the NMPC around the world.

1.4 – Performance

There is a vast literature assessing the performance of IT regimes. Several studies have identified gains stemming from inflation targeting in such areas as lower inflation rates, volatility and inertia, improved expectations, faster absorption of adverse shocks, lower sacrifice ratio, output stabilisation, and the convergence of poorly performing countries toward well performing country standards. For example:

²² '[A]n inflation target [regime] allows the monetary authorities to use all available information, and not just one variable, to determine the best settings for monetary policy' (Mishkin 1998, p.19).

The performance of inflation-targeting regimes has been quite good. Inflation-targeting countries seem to have significantly reduced both the rate of inflation and inflation expectations beyond that which would likely have occurred in the absence of inflation targets. Furthermore, once inflation is down, it has stayed down; following disinflations, the inflation rate in targeting countries has not bounced back up during subsequent cyclical expansions of the economy. Also inflation targeting seems to ameliorate the effects of inflationary shocks.²³

These gains are attributed to the greater credibility and transparency of the system, the improved reputation of the central bank, and the presence of a more flexible institutional framework. Similar gains have been attributed to CBI, especially lower inflation.²⁴

In contrast, other studies have been less supportive of IT and CBI. It has been claimed that there is no convincing evidence that IT improves economic performance as measured by the behaviour of inflation, output or interest rates, and it may even lead to a deterioration of some performance indicators:

[T]he evidence does not conclusively indicate whether inflation targeting has led to a lowering of inflationary expectations and enhanced credibility, thereby mitigating the real output costs that disinflation typically entails. In fact, sacrifice ratios ... do not appear to have been much affected by inflation targeting ... Inflation expectations have come down, in most

²³ Mishkin (1998, p.24). See also Arestis, Caporale and Cipollini (2002), Bernanke et al (1999), Debelle et al (1998), Fatas, Mihov and Rose (2004), King (2002), Landerretche et al (2001), Mishkin (1999), Mishkin and Schmidt-Hebbel (2002), Svensson (1997a, 1997b) and Wu (2004). For detailed country case studies supporting these conclusions see, *inter alia*, Arestis, Caporale and Cipollini (2002), Bogdanski et al (2000), Mayes (1998), Mayes and Razzak (1998), Minella et al (2002) and Mishkin (2004).

²⁴ See, for example, Alesina (1988, 1989), Alesina and Summers (1993), Cukierman (1992) and Grilli et al (1991).

cases, mainly because inflation-targeting central banks were able to demonstrate that they were capable of achieving and maintaining low inflation.²⁵

Alternatively:

Although inflation has fallen, it has been accompanied in most of the seven [IT] countries by higher unemployment ... Comparing unemployment in the inflation-targeting countries with that in other major industrial countries shows that the average unemployment rate rose significantly in the early 1990s in the inflation-targeting countries, but since 1994 has tended back toward the level of the major industrial countries.²⁶

Similar questions have been raised about CBI:

[E]mpirical evidence shows that central bank independence is not associated with higher rates of economic growth or employment, ... financial stability (as excess credit growth and stock and real estate price inflation often occur in the presence of independent central banks), budget balance or a reduced tendency for the central bank to monetize fiscal deficits.²⁷

²⁵ Agénor (2001, pp.43-4).

²⁶ Debelle et al (1998). Cecchetti and Ehrmann (1999) claim that IT increases output volatility even if it helps to reduce inflation, while Neumann and von Hagen (2002) find no evidence that IT is superior to other disinflation strategies. In spite of his strong support for IT, Mishkin (1998, p.24) accepts that 'the likely effects of inflation targeting on the real side of the economy are ... ambiguous. Inflation expectations do not immediately adjust downward following the adoption of inflation targeting. Furthermore, there appears to be little if any reduction in the output loss associated with disinflation, the sacrifice ratio, among countries adopting inflation targeting.'

²⁷ Chang and Grabel (2004, pp.183-4).

These conflicting conclusions are partly due to the different approaches and econometric methodologies used in these studies and, as such, they are no different from the contradictory evidence found in other areas of macroeconomics. However, there may be two additional reasons for these discrepant assessments of IT and CBI.

1.4.1 – Regression towards the Mean

There are strong indications that the economic performance of most OECD countries has improved, in terms of inflation, output volatility and interest rates during the last 10-15 years. These improvements are obvious in both IT and non-IT countries. This seems to indicate that these performance improvements were due to something *other* than IT.²⁸ Moreover, even when the performance of IT countries improves *more* than that of non-IT countries, it cannot be simply assumed that the difference was *due* to IT.

Ball and Sheridan (2003) find strong evidence that the countries showing the greatest improvements were those with the worst performance in the previous period (before the early nineties). In other words, IT countries tended to be those with the worst initial performance and that, perhaps for this reason, were more easily tempted to shift their economic policy towards IT. These countries eventually found that their performance improved – but not *because* of IT. Rather more prosaically, they simply *regressed towards the mean*, which helps to explain the similar improvements observed in countries that did *not* adopt IT. In this sense, the apparent success of IT countries is merely due to them having ‘high initial inflation and large decreases, but the decrease for a given initial level looks similar for targeters and non-targeters’.²⁹

²⁸ See Arestis and Sawyer (2005).

²⁹ Ball and Sheridan (2003, p. 16).

Once they control for regression towards the mean Ball and Sheridan find that there is *no evidence* that IT improves economic performance, including inflation, interest rates, the variance of inflation, output and interest rates, or the persistence of shocks:

There is no evidence whatsoever that inflation targeting reduces inflation variability ... Our robust finding is that inflation targeting has no beneficial effects ... [T]here is no evidence that targeting affects inflation behavior.³⁰

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

A paper that replicates this study in 25 or 50 years may find ample evidence that targeting improves performance. The evidence is not there, however, in the data through 2001.³¹

In sum, in the words of Arestis and Sawyer (2005):

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

³⁰ Ball and Sheridan (2003, pp.11-12).

³¹ Ball and Sheridan (2003, p.17).

1.4.2 – Differences in Economic Structure and Policy Content

Most studies of IT and CBI ignore the differences between the content of the economic programmes implemented in each country, and completely fail to take into account their distinct economic structures. Carare and Stone (2003) attempt to do so, at least implicitly, and their paper offers important pointers for the analysis of the relevance of NMPC for poor countries.

Carare and Stone classify IT regimes into full-fledged inflation targeting (FFIT), eclectic inflation targeting (EIT) and inflation targeting lite (ITL) (see Table 1 and Appendix A).³² Their classification is based on

the clarity and credibility of the central bank's commitment to the inflation target. Clarity is gauged by the public announcement of the inflation target and by the institutional arrangements in support of accountability to the target. Credibility is proxied by the actual inflation outturn and by market ratings of long-term local currency government debt.³³

The appropriateness of this criterion is discussed below.

For Carare and Stone, FFIT is the typical form of IT (which was explained in sections 1.1-1.3 above). The eighteen FFIT countries in their sample are either small or medium-sized industrial economies, or medium and large middle-income countries.

³² Eichengreen (2002) draws a similar distinction between 'explicit' and 'implicit' inflation targeting in the context of middle-income countries. While explicit targeters implement the full gamut of measures required for IT, implicit targeters attempt to stabilise the price level without adopting all the ingredients of outright inflation targeting.

³³ Carare and Stone (2003, p.3).

Table 1 – Inflation Targeting Regimes in 2003

FFIT	EIT	ITL
Australia	Euro Area	Albania
Brazil	Japan	Algeria
Canada	Singapore	Croatia
Chile	Switzerland	Dominican Republic
Colombia	United States	Guatemala
Czech Republic		Honduras
Hungary		Indonesia
Iceland		Jamaica
Israel		Kazakhstan
Mexico		Mauritius
New Zealand		Peru
Norway		Philippines
Poland		Romania
South Africa		Russia
South Korea		Slovakia
Sweden		Slovenia
Thailand		Sri Lanka
United Kingdom		Uruguay
		Venezuela

Source: Carare and Stone (2003). Stone and Bhundia (2004) include Peru and the Philippines among the FFIT countries, and Argentina, Egypt, Iran and Turkey among the ITL countries; they also claim that Honduras, Uruguay and Venezuela are exchange rate targeters rather than ITL.

They ‘have a medium to high level of credibility [and] enjoy a large degree of financial stability ... [but they] are not able to maintain low inflation without a clear [institutional] commitment to an inflation target ... Their ... commitment to the inflation target comes, however, at the price of less flexibility for output stabilization’.³⁴

In contrast, all five EIT central banks are in industrial countries, and they have a history of low inflation, financial stability and very high credibility. These central banks pursue distinct monetary policies, and they do not make a clear commitment to an inflation target.³⁵ In fact, they

have so much credibility that they can maintain low and stable inflation without full transparency and accountability with respect to an inflation target. Their record of low and stable inflation and high degree of financial stability affords them the flexibility to pursue [simultaneously] the objective of output stabilization, *as well as* price stability.³⁶

In other words, EIT central banks avoid a commitment to inflation targets because this would reduce their ability to stabilise output without any additional gains in price stability.³⁷ However, their ‘dual objectives mean that they cannot operate with as much transparency as FFIT countries’.³⁸

The nineteen ITL countries are ‘emerging market economies’.³⁹ They have low credibility and higher and variable inflation rates due to their weak institutional framework, greater government reliance of central bank financing and greater vulnerability to financial instability and economic shocks. These countries

³⁴ Carare and Stone (2003, pp.3-5).

³⁵ Carare and Stone (2003, pp.3, 14).

³⁶ Carare and Stone (2003, p.3), emphasis added.

³⁷ Carare and Stone (2003, p.20).

³⁸ Carare and Stone (2003, pp.4-5).

³⁹ Carare and Stone (2003, p.14).

announce a broad inflation objective but they are unable to commit themselves credibly to a numerical target, because low inflation cannot be their foremost policy objective. Their monetary policies are heterogeneous, because their central banks need to have flexibility to deal with their government's financing needs and, especially, the shocks that regularly buffet their economies:⁴⁰

[A] high degree of clarity is not always optimal when financial stability is an ongoing concern ... Constructive ambiguity, or a deliberate lack of clarity, is needed in the lender-of-last-resort role of the central bank to address the contagion and moral hazard problems inherent in potential bailouts of banks that can be deemed 'too big to fail' ... The less clear commitment to an inflation target of ITL central banks provides more scope for dealing with financial crises.⁴¹

Finally, very small poor countries are unable to commit to any form of ITR, however 'lite', because of their underdeveloped financial sectors and concentrated production profiles. These countries tend to choose fixed exchange rate regimes or to adopt the currency of their largest trading partner.⁴²

Carare and Stone conclude their study with guidance notes for switches from one regime to another. Switches from FFIT to EIT would be possible if the central bank's inflation-fighting credibility becomes so entrenched that it can 'reduce the clarity of its commitment to its inflation target without an increase in inflation expectations. But no country has actually undertaken this regime change'.⁴³ Conversely, a 'switch from EIT to FFIT depends on whether the long-run gain in

⁴⁰ 'This [ITL] regime covers a grab-bag of monetary frameworks with variable weights to inflation, exchange rate and monetary objectives and intermediate targets' (Stone and Bhundia 2004, p.10).

⁴¹ Carare and Stone (2003, p.20); see also pp.4-5, 14-15.

⁴² Carare and Stone (2003, p.6).

⁴³ Carare and Stone (2003, p.5).

inflation-fighting credibility outweighs the loss in flexibility to achieve other objectives'.⁴⁴

Switches from ITL to FFIT may be relevant for a larger number of countries. For Carare and Stone, ITL can be seen as 'a transitional regime during which the authorities implement the structural reforms needed for the credible adoption' of FFIT.⁴⁵ The switch would be facilitated by 'a deep and broad financial sector, which reduces systemic risks and potential policy conflicts, provides for market-based monetary policy implementation, and allows the government to raise the bulk of its funding in financial markets'.⁴⁶

Carare and Stone's study is important because it shows that FFIT requires minimum levels of institutional development, financial depth and economic stability (see section 4). Carare and Stone also rightly point out that in spite of its potential advantages (outlined in sections 1.1-1.3) FFIT entails costs, especially the loss of policy flexibility, which need to be factored into each country's strategic policy decisions. In particular, while some countries *can* afford to lose their monetary policy flexibility in order to achieve low inflation others *cannot* because their economies are too fragile. Finally, a small number of privileged countries can afford to preserve their policy flexibility while, at the same time, maintaining low inflation rates. Carare and Stone's study implies that monetary policy choices are constrained by the *material* differences between countries, and these differences are determined by their distinct levels of development, institutional arrangements, trajectory and economic problems.

In spite of these valuable conclusions, Carare and Stone do not directly acknowledge the decisive role of these material constraints in the determination of

⁴⁴ Carare and Stone (2003, p.24).

⁴⁵ Carare and Stone (2003, pp.3-4). For Stone and Bhundia (2004, p.10), '[i]nflation targeting lite can be viewed as a transitional monetary regime aiming at maintaining monetary stability until the implementation of structural reforms in support of a single nominal anchor'.

⁴⁶ Carare and Stone (2003, p.5).

economic policy. Instead, their attempt to grapple with these constraints is marred by the substitution of the wholly subjective concept of ‘credibility’ for measures of institutional development, financial fragility and external vulnerability. In other words, Carare and Stone’s use of ‘credibility’ to underpin their classification of policy regimes obscures the role of other, more relevant variables that are trapped in the background.

1.4.3 – Summing Up

Although there is some scope for disagreement with the classification schemes used in the available studies, a growing number of countries has been turning to IT and CBI as their preferred monetary policy framework.⁴⁷ While IT is not formally sponsored by the international financial institutions, even the most cursory perusal of IMF publications will reveal a favourable assessment of this policy regime. The Fund is even more bullish about the potential advantages of CBI, and the central banks of several poor countries have been granted operational autonomy or independence in the context of their recent agreements with the IMF.⁴⁸ This is partly a reflection of the growing popularity and academic prestige of the NMPC around the world.

Given their growing popularity and prestige, it is odd that a vast literature has failed to confirm beyond reasonable doubt the superior performance of IT and CBI regimes. The conflicting evidence in numerous studies seems to indicate that IT and CBI can make only a minor (if any) contribution to performance improvement in such diverse areas as credibility, expectations, inflation rates, output growth, interest rates and the sacrifice ratio).⁴⁹

⁴⁷ See Agénor (2001, pp.40-1).

⁴⁸ See IMF (2002).

⁴⁹ See Chang and Gabel (2004, p.183).

These statistical difficulties may be due to four reasons. First, it is extremely difficult to classify policy regimes objectively as the starting point for the investigation of performance differences. Countries can be grouped according to whether or not they follow explicit IT policies, or whether or not their central banks follow hierarchical or dual mandates. They can be regrouped according to their ‘explicit’ or ‘implicit’ inflation targeting strategies, or rearranged into full-fledged, eclectic or ‘lite’ inflation targeters. It is even more difficult to classify countries according to the degree of autonomy of their central banks (see section 3.5). If one also controls for the structural differences between the economies being contrasted, as is essential for any meaningful study, the available samples become insignificantly small making meaningful comparisons impossible.

Second, IT and CBI experiences are relatively new in most countries. For example, Stone and Bhundia (2004) list twenty FFIT countries, only five of which targeting inflation for more than ten years.⁵⁰ Another five have been targeting for more than five years,⁵¹ and ten for an even shorter period.⁵² It is impossible to draw meaningful conclusions based on these short and disparate sample periods. This limitation implies that it is impossible to reject the hypothesis that IT and CBI countries simply reverted towards the mean – i.e., their superior performance, even if it could be demonstrated, is simply a statistical fluke.

Third, and related to the previous point, even the supporters of IT admit that this is *not* an inflation stabilisation strategy. Consequently, although high inflation countries may be more inclined to adopt IT, they can do so only *after* a successful disinflation programme that is entirely unrelated to IT. On adoption, the ITR will almost invariably inherit declining inflation rates, growing monetary policy credibility and, quite possibly (if their economies have been in the doldrums for

⁵⁰ Australia, Canada, New Zealand, Sweden and the UK.

⁵¹ Brazil, Chile, Czech Republic, Israel and Poland.

⁵² Colombia, Hungary, Iceland, Norway, Mexico, Peru, Philippines, South Africa, South Korea and Thailand.

long periods) healthy economic growth rates. These favourable developments are *causes* of IT rather than its effects, and they need to be factored into the assessment of the performance of the ITR.⁵³

Fourth, the last fifteen years have been relatively tranquil by post-Bretton Woods standards. Although growth rates have deteriorated steadily, inflation has been declining strongly almost everywhere (see Boxes 1, 2 and 3, appendix B).

Although several countries have experienced profound economic crises recently these were mostly due to exchange rate and balance of payments difficulties; high inflation is no longer a problem in the vast majority of countries.

These features of the world economy create problems for the assessment of IT and CBI regimes, because it is extremely difficult to assess the impact of different economic policies on performance under relatively stable circumstances at home and abroad. In other words, in the absence of economic turbulence the range of possibly successful policies is too broad to permit discrimination between them, and IT ‘may have had little impact over what any sensible strategy could have achieved’.⁵⁴ The most obvious grounds on which to distinguish country performances is not even their policies, but their structural economic features.⁵⁵

In conclusion, IT and CBI seem to have little or no influence in economic performance, and the performance differences that can actually be observed were due to other reasons.⁵⁶ Why, then, does the mainstream economic discourse place so much emphasis on IT and CBI? This question cannot be addressed in this paper, but three contributing factors can be easily identified. First, mainstream theory is structurally predisposed to see value in IT and CBI, since they share the

⁵³ See Arestis and Sawyer (2005).

⁵⁴ Arestis and Sawyer (2005).

⁵⁵ ‘IT emerging market economies (EMEs) have had a relatively worse performance. In these countries, deviations from both central targets and upper bounds are larger and more common ... [I]n comparison to developed economies, the volatilities of all variables – inflation, exchange rate, output and interest rate – and the inflation level are higher in EMEs’ (Fraga et al 2003, pp.4, 8).

⁵⁶ See Arestis and Sawyer (2005).

same methodological foundations (real-monetary dichotomy, quantitativism, and so on; see section 1.1). Second, IT and CBI are *fashionable*, and they have become part of the ‘common sense’ of our age. Therefore, these policy recommendations tend to creep unthinkingly into even heterodox discourse (see section 2.1).⁵⁷ Third, IT and CBI unwittingly promote the interests of domestic and international finance, which ensures that these policy recommendations will tend to find support among an extraordinarily powerful constituency (see sections 3.5 and 3.6).

⁵⁷ For example, Fontana and Palácio-Vera (2002) find a ‘growing consensus’ between the NMPC and post-Keynesian monetary analysis, which is theoretically nonsensical and would be alarming at the level of policy advice.

2 – Inflation Theory and Policy in the NMPC

The inflation theory underpinning the NMPC and the ensuing policy recommendations are open to question on several counts, reviewed below. They include the theory of inflation, its economic implications, and the potential costs of inflation. These aspects of the NMPC are critically discussed below.

2.1 – The Theory of Inflation

The NMPC is *fashionable*. It incorporates the most advanced economic theory, is attractively packaged, and its policy recommendations are easy to understand and defend. These policies promote powerful interests which can also be presented as the ‘common good’ (see section 3) – and it has been claimed that these policies *work* (see, however, section 1.4). In what follows, the inflation theory underpinning the NMPC is scrutinised from four angles, ‘economics fashions’, fashionable theories of inflation, their implications for anti-inflation policy, and other insufficiencies of mainstream inflation theory.

2.1.1 – Economics Fashions

Economic theory is regularly afflicted by changing *fashions*. The rise and decline of economics fashions is determined by several factors. They include external events, especially the internal development of economic theory (as was shown in section 1.1.4, in the case of CBI and IT), economic fluctuations (instability and underperformance favour the development of new ideas, such as Keynesianism in the thirties and monetarism in the late sixties and early seventies, while booms tends to consolidate the prestige of the current fashions), structural social changes and other macro-social developments (e.g., the Welfare State left its imprint in several branches of economic theory), and the incorporation of exciting developments outside economics.

At a macro or long-term level, Keynesianism was fashionable between the thirties and the sixties, monetarism in the seventies, new classical economics in the eighties, and new Keynesianism and new institutionalism in the nineties. At a micro or short-term level, the growing popularity of chaos theory in physics and mathematics encouraged attempts to introduce chaotic models into economics in the late eighties and early nineties regardless of their relevance or applicability, while the 'latest' econometric technique regularly influences the direction and content of economic research whether or not they can contribute to the progress of economic analysis.¹

In spite of these reservations, economics fashions are not necessarily dangerous or wrong, and they can contribute to the long-term progress of economics. However, the theoretical insights and economic policies suggested by the latest fad must be internally consistent and empirically useful. Even in this case, practitioners and policy-makers must be prepared to abandon them once the material conditions underpinning their applicability have changed.² Both problems have plagued the mainstream theory of inflation during the last half century.

2.1.2 – Fashionable Theories of Inflation

Mainstream claims for the identification of a 'general' theory of inflation have appeared at frequent intervals, usually in connection with long-term economics fashions. For example, in the postwar (Keynesian) 'golden age' inflation was normally assumed to be due to cost pressures, especially rising wages and balance of payments difficulties. Policy recommendations included incomes policies and adjustments to the Bretton Woods System, to allow different rates of productivity growth to be absorbed by changes in the exchange rates rather than through rising inflation, unemployment or different GDP growth rates. Between the late sixties

¹ Fine (2001, ch.7) reviews the role of economics fashions in the context of social capital.

² See, in this context, the excellent study by Watson (2002).

and the early eighties inflationary pressures were assumed to result from adverse supply shocks, excess money supply growth and excessively optimistic assumptions about the stability of the Phillips curve. Many mainstream economists turned towards monetarism, and advised governments to avoid tampering with the Phillips curve, reform the labour market to increase 'flexibility' and cut costs, and impose money supply targets in order to bring inflation under control.³

Unfortunately for the monetarists, the experiences in Germany, Switzerland, the UK, the US and elsewhere did not vindicate their claims that money supply targeting was either feasible or conducive to inflation stabilisation.⁴ In addition to these practical difficulties, monetarist theory was badly damaged by the severe criticisms inflicted by new classical, Keynesian and radical political economists.⁵ Briefly, the Keynesians and the radical political economists argued, first, that the velocity of money and the money demand function are unstable and, therefore, that the relationship between money supply and nominal income is unpredictable. Therefore, even if money supply targeting were feasible it would be insufficient to control inflation.

Second, although there is always some relationship between changes in the stock of money and changes in the price level, this does not imply that the growth of the money stock *determines* the rate of inflation. Therefore, money supply targeting can help to squeeze inflation out of the economy, but only slowly and unreliably, and potentially at a high cost. Third, government attempts in the seventies and eighties to control the money supply while, at the same time, liberalising the financial system and the capital account of the balance of payments were self-defeating. Liberalisation modified the monetary transmission process and the links

³ See, *inter alia*, Laidler (1981) and Laidler and Parkin (1975).

⁴ See Arestis and Sawyer (1998b).

⁵ For an overview of these debates, see Carlin and Soskice (1990), Levacic and Rebmann (1982) and Sawyer (1989).

between money, finance and output. It also created incentives for the development of a whole host of financial instruments that blurred the definition of the monetary aggregates and bypassed the existing controls over the supply of money, throwing the entire exercise into confusion.⁶ The new classical economists also criticised heavily the monetarist experiment. In spite of their general agreement with the monetarist theory of inflation, the new classicals claimed that the policy shift towards money supply targeting induced changes in private sector behaviour that invalidated the predictions of the existing econometric models. Therefore, the monetarist policy recommendations were doubtful, and they may even be unhelpful.

The shortcomings of monetarism and the heavy criticisms levelled by its opponents contributed to the development of a vast literature on inflation and stabilisation since the mid-eighties, mostly drawing upon the monetarist and new classical theories of inflation (see section 1.1). In the absence of significant wage pressures or major supply shocks during this period, inflation has become increasingly associated with fiscal deficits and, especially, with the lack of government policy credibility. This diagnosis of inflation led to recommendations for increasing credibility, and introducing nominal anchors (initially exchange rate and, later, inflation targeting) in order to thwart the government's incentive to surprise the public with unexpected inflation. These recommendations were usually accompanied by pressures for CBI and trade and capital account liberalisation in order to dismantle selected features of the Welfare State, increase labour market flexibility even further, curtail the remaining sources of labour

⁶ These criticisms were eventually accepted by the mainstream: 'monetary targeting requires adequate knowledge of the parameters characterizing the demand for money. In an economy undergoing rapid financial liberalization, however, these parameters (notably the interest elasticity of money demand) may be highly unstable. In such conditions money ceases to be a good predictor of future inflation; that is, the relation between the intermediate target and the final objective becomes unstable. Similarly, in a context of disinflation, the demand for money may be subject to large and unpredictable shifts; as a consequence, the information content of money for future inflation will be very low. Both arguments suggest that relying on monetary aggregates can be potentially risky' (Agénor 2001, pp.19-20). See also Mishkin (1998, p.14).

unrest and impose finance-friendly forms of fiscal and monetary policy discipline on presumably reluctant governments (see section 3).⁷

In the mid-nineties, the NMPC had already become fashionable and the hegemonic framework informing anti-inflation policy. This policy regime was perceived to be the most conducive to the consolidation of the low inflation regime recently achieved in the rich countries. The NMPC also seemed to have something to offer to the middle-income and poor countries, even though their central banks generally lack experience supervising complex, liberalised and internationally integrated financial systems (which were, nevertheless, being imposed by external as well as internal pressure). In these countries, the NMPC can presumably deliver greater economic stability, institutional transparency, objective monetary policy rules, standardised channels for the diffusion of information and, hopefully, lower the costs of international financial integration (see section 4).

2.1.3 – Economics Fashions and Anti-Inflation Policy

The shift of inflation theory away from Keynesianism and towards monetarist views (including its successors, such as the NMPC) had three significant implications for economic policy-making. First, it has fostered the prominence of monetary or excess demand factors at the expense of supply or cost factors. This is unfortunate, because detailed studies of inflation generally find that both aspects are essential. In order to explain sustained inflationary episodes simplistic descriptions of the government's fiscal, monetary, exchange rate and financial policy stance are rarely sufficient. It is also necessary to take into consideration the country's position in the international division of labour, the structure of the local value chains (including the degree of oil dependence, the relations between industry and agriculture, and so on), their vulnerability to adverse terms of trade

⁷ See Gowan (1999), Panitch and Gindin (2005) and Rude (2005).

movements, the system of labour relations, the economy's wage and price-setting mechanisms, the influence of distributional conflicts, and other factors.

Although mainstream economics does not deny the potential influence of these factors, it tends to dismiss their long-term implications or to claim that, at the end of the day, they are irrelevant because all inflationary pressures can be neutralised by monetary policy. This is questionable. Experience suggests, first, that each time that a 'general' theory of inflation has been identified, it has been a fashionably different theory. It follows that none of these theories were really general, as would be demonstrated by their failure to interpret the onset of new inflationary pressures, and their eventual inability to inform economic policy.

Second, inflation changes over time and differs across countries and regions.⁸ It is therefore unlikely that any 'general' theory of inflation is possible, or that 'one size fits all' anti-inflation policies can be *efficient* (least cost), even if they are *effective* (capable of eliminating high or unstable inflation). Each inflationary episode is unique, and efficient anti-inflation policies will tend to combine distinct policies operating at different levels.

Moreover, even if a given anti-inflation policy is optimal in a given context, its efficiency and effectiveness could be entirely different in another set of circumstances. In sum, following the latest fashion can help to increase one's credibility, which is valuable in itself, but popularity could be a poor guide to economic policy.

⁸ For example, the French economy experienced very similar rates of inflation in the early sixties and in the late eighties and early nineties, but no economist would claim that they indicate that the underlying circumstances and the government's policies were identical during these periods. By the same token many Latin American countries and several Eastern European and former Soviet countries experienced very high rates of inflation in the late eighties and early nineties, but their causes were profoundly different.

2.1.4 – Other Insufficiencies of Mainstream Inflation Theory

It was shown above and in section 1.1 that mainstream inflation theory distinguishes between a ‘technical’ monetary policy, drawing upon the real-monetary dichotomy, and a ‘political’ fiscal policy, that can be time-inconsistent and create an inflation bias. However, this distinction is untenable for two reasons.

First, fiscal and monetary policies are inseparable. Contractionary monetary policy does not simply slow down the economy and mechanically reduce inflation. It also increases the cost of the domestic debt service, which has an immediate fiscal impact especially if the public debt is already large or if the state’s budget constraint is tight. High interest rates also increase the private sector’s borrowing costs, which affects the unemployment rate, the level and composition of the output (highly leveraged firms and relatively unprofitable sectors will tend to be penalised more heavily), and the state’s tax revenues. They create incentives for foreign borrowing and capital inflows, which requires sterilisation and can create large fiscal costs. They also redistribute income towards finance. In extreme circumstances monetary policy tightening may trigger a financial crisis, with severe consequences for fiscal policy and the economy as a whole. It is simply wrong to presume that one part of economic policy is sealed off in a neutral ‘technical’ department, while the ‘political’ department only is involved in the rough-and-tumble of daily politics, and should be answerable to the voters.

Second, the mainstream assumption that governments tend to follow time-inconsistent policies is also untenable, because it contradicts the rational expectations hypothesis. Rational economic agents should *know* that there is no long-term trade-off between inflation and unemployment – so why should they, as

voters, irrationally elect such a scheming government in the first place?⁹ This contradiction is important because the time-inconsistency hypothesis underpins the demand for an independent central bank – a public institution funded by the taxpayers but impervious to ‘irrational’ social or electoral pressures.

This logical difficulty brings to light the undemocratic implications of mainstream inflation theory. This theory departs from the assumption that the economic agents can be represented by a single individual who, being rational, is also a neoclassical economist. This definitional sleight of hand turns the mainstream economists into the intellectual guardians of social welfare, regardless of the wishes of the electorate, the political process, or the social and political divisions that may exist in the real world.¹⁰ These implications of mainstream inflation theory – including the NMPC – are incompatible with the most basic principles of representative democracy and political accountability. Milton Friedman was therefore right when he said that ‘money is too important to be left to the central bankers’.¹¹ There is simply no substitute to democratic policy-making and the openness and accountability of the public institutions (see section 5).

Mainstream inflation theory is not only inconsistent and undemocratic; it also operates at an excessively high level of abstraction. This makes the theory uninformative and excessively general, and leads to ‘horizontal’ anti-inflation policies (e.g., money supply, exchange rate or inflation targeting) that fail to distinguish the role of the ‘vertical’ (sector and historically specific) features of

⁹ ‘It is true that the model argues that democracy brings a cost with no economic benefit. But the behaviour which generates the cost is entirely lacking in a rationale. In the model one [political] party has a greater desire than the other to reduce unemployment, but the assumed structure of the economy means this can manifest itself only as a higher rate of inflation. Thus, fundamentally, the electorate are choosing rates of inflation. The difficulty is that no explanation is offered as to why parties favouring different rates of inflation continue to exist when voters understand that inflation brings no benefits. The parties are in effect being exogenously given policies which do not make sense in the context of the model, whereas one would have expected the members of the pro-inflation party, recognising that it brings no benefit, to change the policy’ (Forder 2003, pp.22-3).

¹⁰ See Watson (2002, p.187).

¹¹ Cited in Chowdhury (2004a, p.25).

specific inflationary episodes. This bias towards excess abstraction is, in part, a reflection of the insufficiencies of mainstream economics, which is structured around ‘equilibrium’ positions determined simultaneously by all the variables in the system. In this case, it is difficult to ascertain the *causes* of disequilibrium (e.g., persistent inflation) in a logically consistent manner, and to devise specific, low cost policies to address them.

Finally, mainstream theory is also misleading. It purports to be ‘neutral’ and to advocate technically ‘efficient’ solutions to severe economic problems but, in fact, it fosters the narrow interests of finance above all others (see sections 3.5 and 3.6). Policies inspired by the mainstream approach detract from the achievement of MDGs, and they should be replaced by pro-poor alternatives (see section 5.3).

2.2 – Economic Implications of Inflation

Given the strong emphasis of mainstream theory on the costs of inflation (see section 1.1.1), it may seem surprising to find how thin is the literature addressing this issue. This section briefly considers four potential macroeconomic implications of inflation, without any attempt to quantify their potential trade-offs. They include the relationship between inflation, growth and unemployment, the costs of moderate inflation, and the distributive and financial implications of inflation.

2.2.1 – Inflation, Growth and Unemployment

It was shown in sections 1.1.1 and 1.1.2 that mainstream theory claims that there is a short-term trade-off only between inflation, growth and unemployment, but there is no long-term trade-off. It also claims that high and variable inflation carries significant costs in terms of growth and unemployment. In this case, it may be worth paying a substantial short-term cost to reduce inflation, in order to enjoy higher growth rates and levels of welfare in the long-term.

Take, for example, the study by Ghosh and Phillips (1998) examining the relationship between inflation, disinflation and output growth in IMF member countries between 1960 and 1996. The main findings of this study were, first, that inflation is ‘one of the most important determinants of GDP growth (second only to physical and human capital).’¹² Moreover, ‘of the various factors that might affect growth, perhaps none is as readily changed in the short-run as the inflation rate’,¹³ suggesting that anti-inflation policy can play an important role in the promotion of sustainable growth.

Second, there is a ‘statistically significant and ... economically interesting’ negative relationship between inflation and growth. Although part of this relationship may stem ‘from effects of growth on inflation, we still find a statistically and economically significant relationship between inflation and GDP growth when we use several sets of instruments to control for such simultaneity’.¹⁴

Third, this relationship is nonlinear, in two senses: ‘at very low inflation rates ... inflation and growth are positively correlated. Otherwise, inflation and growth are negatively correlated’. Moreover, ‘the decline in growth associated with an increase from 10 percent to 20 percent inflation is much larger than that associated with moving from 40 percent to 50 percent inflation’.¹⁵ This implies that there is ‘an optimal or growth-maximizing rate of inflation’ around 2-3 per cent per annum (this kink cannot be identified precisely, but it is certainly below 5 per cent).¹⁶

Fourth, disinflation is not bad for growth; in fact, the ‘short-run growth costs of disinflation are only relevant for the most severe disinflations, or when the initial

¹² Ghosh and Phillips (1998, p.675).

¹³ Ghosh and Phillips (1998, p.708).

¹⁴ Ghosh and Phillips (1998, p.674).

¹⁵ Ghosh and Phillips (1998, p.674); see also p.678.

¹⁶ Ghosh and Phillips (1998, p.697).

inflation rate is well within the single-digit range'.¹⁷ However, starting 'from inflation rates above 6 percent, only the most drastic disinflations (at least halving the inflation rate in a single year) are associated with any negative impact on growth (which itself is largely offset by the higher growth associated with the new lower level of inflation)'.¹⁸

Findings such as these have been questioned by a substantial literature, not always heterodox. For example, it has been claimed that there is no statistically significant relationship between inflation and growth,¹⁹ that disinflation does carry significant short-term costs,²⁰ that moderate inflation is not bad for growth (see section 2.2.2), that inflation is not always costly for the poor (see section 2.2.3), and that estimates of the costs of inflation systematically ignore the costs of unemployment, stagnation and technological backwardness (see section 3).

If there is a trade-off between inflation, growth and unemployment it must be both elusive and unstable, as is shown by the conflicting evidence found in the literature and the frequently changing estimates of the 'equilibrium' rate of unemployment in most economies.²¹ Mainstream studies often generalise on the basis of a few cases of extremely high inflation in which growth was simultaneously compromised, and where the resumption of growth was accompanied by the elimination of high inflation. It is certainly likely that very high inflation creates obstacles to growth; in these cases, stabilisation could facilitate the growth of output and productivity. However, high inflation and low growth rates could be merely *symptoms* of other economic problems (e.g., the process of transition in the former socialist countries), in which case stabilisation *per se* may not be conducive to the resumption of growth.

¹⁷ Ghosh and Phillips (1998, p.672).

¹⁸ Ghosh and Phillips (1998, p.675).

¹⁹ See Kirkpatrick and Nixon (1987) and the references therein.

²⁰ See Dornbusch and Fischer (1991).

²¹ See Arestis and Sawyer (2005, table 2).

It is likely that a *general* trade-off between inflation, growth and unemployment is simply non-existent, since economies are known to grow rapidly for long periods – often for several years – with stable or falling unemployment, and without any significant inflationary pressures (see Box 4, appendix B). In other words, this trade-off cannot simply be assumed to exist, or even be ‘demonstrated’ through panel data analysis. Since the relationship between these variables is likely to shift significantly depending on the structural and institutional features of the economy, its stage in the cycle and the state’s economic policies, this trade-off has to be shown to exist (or not) for each economy, and in every period. It would be misguided to design economic policy under the assumption that there is a stable and universally valid trade-off between inflation, growth and unemployment, since none may be present.

The case for the superiority of price stability can also be questioned on the basis of estimates of this presumed trade-off. For example, Forder (2003, p.14) reports that holding the US unemployment rate 1 per cent below the NAIRU for a year results in an increase in inflation of only 0.3 per cent.

Alternatively, suppose that Milton Friedman is right, and that it takes many years for expected inflation to catch up with reality. If a country adopts a policy of gradually raising inflation over thirty years, and manages to keep unemployment two per cent below its natural rate during the entire period,

we can perform a thoroughly back of the envelope cost-benefit calculation. Over the 30 year period, the total of output in excess of the natural level will be about 60% of one year’s GDP. At a rate of return of 5%, that extra output, if invested, is worth 3% of GDP per year in perpetuity. On the cost side we have an equilibrium rate of inflation of 10%. The question,

therefore, is whether we would think such an increment in income is worth the price of the inflation.²²

Finally, suppose that there is a natural rate of unemployment but this rate is unknown at any point in time. It may therefore be worthwhile to adopt a policy of ‘cautious expansionism’, testing the limits of growth even at some risk of increasing inflation, especially if the cost of inflation is not extraordinarily high (as was claimed above).²³

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

2.2.2 – Moderate Inflation

Several studies indicate that moderate inflation, around 10-40 per cent per annum, does not always have negative economic consequences, and does not tend to accelerate. Moderate inflation is not associated with slower growth, lower investment, higher unemployment, less foreign direct investment, or the deterioration of any other important real variables.²⁴ It is even possible that moderate inflation will help to *sustain* economic growth, especially when there is excess capacity and significant unemployment or underemployment.

It has also not been shown convincingly that moderate inflation is harmful either to the poor, or for the distribution of income (see section 2.2.3). Quite the

²² Forder (n.d.).

²³ This suggestion made by Joseph Stiglitz is cited by Forder (n.d.).

²⁴ See, for example, Bruno (1985), Bruno and Easterly (1996), Chang and Grabel (2004, ch.11), Dornbusch and Fischer (1991), Epstein and Yeldan (2004) and Rao (2002).

contrary, moderate inflation has been reported to be associated with *higher* incomes for the poorest, and monetary contraction with a *worsening* of the relative position of the poor.²⁵ In fact, several studies claim that excessively *low* inflation can be bad for growth, especially if prices and wages are sticky downwards (see sections 2.2.1, 3.1 and 4.5).

In sum, it seems, first, that the relationship between inflation and growth is non-linear. Second, the optimal rate of inflation can change in space and in time, and it may even be positively correlated with the rate of economic growth:

While some will interpret this as a licence for big spending, huge deficits and hyperinflation, we simply point out that there is no strong evidence in support of the argument that very low inflation is either pro-growth or pro-poor. Actually, too low an inflation rate can be as harmful to the poor as too high a rate of inflation.²⁶

Third, even though high inflation *can* harm the poor, excessively low inflation and conventional stabilisation policies can have the *same* result (see section 3).

Therefore, there seem to be no grounds to claim that inflation should always be maintained in the 0-5 per cent range, as tends to be the case in IT countries (see Box 4).²⁷

2.2.3 – The Distributive Implications of Inflation

Mainstream theory traditionally claims that inflation is especially costly for the poor (see section 1.1.1). This is because the earnings of the poor (mainly wages, pensions and benefits) are fixed in nominal terms, and they tend to be easily eroded by inflation. The poor also hold a larger share of their assets in liquid form

²⁵ Forder (2003, pp.16-17); see also Vandemoortele (2004, p.13) and Weeks et al (2002).

²⁶ Vandemoortele (2004, p.13).

²⁷ See McKinley (2003).

when compared to the rich, and these assets are immediately devalued by inflation. Finally, the poor find it difficult to hedge against inflation because they lack access to the financial system.²⁸

These losses are probably true.²⁹ However, this is not the full picture. First, many poor people, especially in rural areas, are relatively less exposed to the monetary economy and less dependent on cash earnings than the (possibly less poor) urban population. Second, the poor are often net debtors, and inflation may reduce their debt burden. Third, if the relative price of food increases through inflation at least some of the poor might benefit, if they are net food producers. Fourth, experiences in Latin America have indicated that it is the middle-class that is especially vulnerable to high inflation, because they are highly dependent on monetary exchanges, have little surplus cash to invest and do not have much access to own produced basic goods.³⁰

Finally, numerous studies show that the poor are heavily and disproportionately penalised by conventional (mainstream) disinflation programmes.³¹ These programmes normally generate absolute *as well as* relative losses for the poor, that is, they tend to make the poor poorer and the rich relatively (if not absolutely) richer. This is because they reduce the rate of economic growth and the real wages, increase the rate of unemployment and the cost of debt, and eliminate protective labour regulations that previously helped to protect the standard of living of the poor (see section 4).

It seems that there is no linear or stable relationship between inflation and the distribution of income, in either the short or the long-run. This relationship is

²⁸ For an overview of these arguments see, for example, Pasha and Palanivel (2004, p.13) and Sahay, Cashin and Mauro (2001, p.6).

²⁹ Sahay, Cashin and Mauro (2001, p.6) claim that although inflation erodes the poor's wages, the confiscation of their savings is *not* especially serious because they hold little cash.

³⁰ See Pasha and Palanivel (2004, p.13) and Vandemoortele (2004, p.13).

³¹ See, for example, Garuda (2000), Pastor (1987) and Vreeland (2002).

indirect and highly complex, and simplistic claims that inflation is always worse for the poor tend to draw on a small number of unrepresentative cases. Moderate inflation, in particular, seems to have *no* significant impact on poverty or distribution, if one controls for the rate of economic growth.³² In their careful study of inflation, growth and poverty in Asia, Pasha and Palanivel conclude that:

The lack of sensitivity of poverty to inflation is one of the potentially more important findings of [this] paper. It highlights that the trade-off faced by policies, fiscal or monetary, between growth and inflation from the viewpoint of impact of poverty is not as severe as has traditionally been thought. It appears that to the extent that expansionary policies are resorted to with the objective of stimulating the process of growth, then any resulting inflation is likely to be less damaging on poverty. This clearly strengthens the case for pursuing expansionary fiscal and monetary policies at a time when space already exists, as inflation rates are currently low throughout the region.³³

Similarly, Bulř (2001) claims that the distributive impact of inflation is non-linear, that is, inflation increases income inequality, but this effect is strongest at very high rates of inflation:

[H]yperinflation dramatically worsens income distribution ... countries with either high or low inflation have Gini coefficients that are lower by about 7 or 8 Gini points, respectively, than countries with hyperinflation.³⁴

There seems to be a kink in the impact of inflation on distribution at very low rates of inflation. This kink works both ways, implying that a reduction in inflation from hyperinflationary levels reduces income inequality significantly,

³² See Pasha and Palanivel (2004, pp.14-15).

³³ Pasha and Palanivel (2004, pp.15-16).

³⁴ Bulř (2001, p.151).

but further disinflation towards very low rates of inflation bring about negligible distributive gains.³⁵

Although these distributive effects are statistically significant, Bulíř points out that they are small:

There is little reason to assume that changes in inflation can cause a major swing in a country's income distribution rapidly. If this were so, we would observe much larger annual swings in income distribution because inflation is prone to cyclical fluctuations.³⁶

In other words, it would be misguided to try to address ingrained problems of poverty and inequality through anti-inflation policies. Serious attempts to alleviate poverty and improve the distribution of income require *specific* programmes involving several levels of government, rather than primarily or exclusively the monetary authorities (see section 5.3).

Finally, it is curious that, even though the poor are supposed to lose heavily through inflation, it is *finance* that tends to complain most loudly about the damage caused by inflation, and to demand its elimination through *mainstream* stabilisation programmes, among them IT and CBI (see section 3). This may indicate that – regardless of who actually loses out from inflation – mainstream stabilisation programmes systematically favour finance:

Independent central banks are structurally biased towards the interests of the financial community, an interest group for whom low inflation is of paramount importance. While there are other interest groups that are also harmed by inflation (e.g. those living on a fixed income, such as

³⁵ See Bulíř (2001, pp.139, 151, 154).

³⁶ Bulíř (2001, p.146).

pensioners), the economic interests of the financial community are most directly and profoundly harmed by inflation. It is therefore unsurprising that the financial community – a community that is mobile, politically powerful, and maintains strong international ties – is such a forceful advocate of central bank independence, an institutional form that maximizes the opportunity for monetary policy that is in its interests.³⁷

In fact,

the industrial community and export-oriented producers (and those employed in their enterprises) do not share with financiers an obsession with the prevention of inflation through restrictive monetary policy. Industrialists are often damaged by increases in borrowing costs that result from increases in interest rates. In addition, export-oriented producers are also often harmed by the appreciation of the domestic currency that results from an increase in interest rates ... Thus the distributional effects of the monetary policy pursued by independent central banks are far from neutral.³⁸

This insight may be substantiated by the positive relationship that seems to exist in many countries between *high* real interest rates (an essential element of mainstream stabilisation programmes) and *high* Gini coefficients (see Box 5, appendix B).

³⁷ Chang and Grabel (2004, pp.182-3).

³⁸ Chang and Grabel (2004, pp.183).

2.2.4 – The Financial Implications of Inflation

Mainstream theory claims that inflation contributes to economic inefficiency and underperformance through demonetisation and the reduction of financial system depth.

This is plausible, but it is not necessarily the end of the story. The financial consequences of inflation depend, among other things, on the structure of the monetary and financial systems, their relationship with the productive and foreign sectors, the sources and uses of saving, and the relationship between finance, industry and the state. For example, inflation could induce wealth holders to shift their savings from monetary and financial assets to investment in plant and equipment, which could assist the process of growth.³⁹ Alternatively, inflation could create incentives for the development of index-linked financial assets that may help to *deepen* the financial system.⁴⁰ It is impossible to draw generally valid conclusions, especially in cases of moderate inflation.

2.2.5 – Summing Up

This section has indicated that there are no grounds to presume that there is a *general* relationship between inflation and unemployment, growth, financial development or income distribution. It is also possible that moderate inflation may carry no significant costs, and it may even be conducive to faster growth. In contrast, excessively low inflation *may* be costly (there is no dispute about the negative implications of high inflation), and mainstream stabilisation programmes *can* be highly costly for the poor.

³⁹ See Chowdhury (2004a).

⁴⁰ This seems to have been the case in Brazil, see Goldsmith (1986) and Lees, Botts and Cysne (1990).

In these circumstances, it would be unwise to impose on poor countries a rigid institutional framework compelling the central bank to pursue very low rates of inflation with little regard to the costs of this strategy and the costs of low inflation. After all, why should governments give absolute priority to possibly non-existent problems to the exclusion of really existing economic ills, and relentlessly promote inflation control as the cornerstone for a healthy economy when there is no consistent evidence supporting this claim? This misguided priority may be part of an attempt to foster on society the interests of the domestic and international financial sector. In this case, CBI and IT would be inimical to the achievement of pro-poor outcomes. This claim is discussed in the next section.

3 – The Costs of CBI and IT

This section considers the potential costs of the NMPC. Six types of costs are considered below, the costs of low inflation, the costs of using interest rates to control inflation, the costs of conflicts between IT and balance of payments equilibrium, the costs of the central bank's dual mandate, the costs of CBI and the costs of agency capture and financial bias.

3.1 – The Cost of Targeting Very Low Inflation

The first important cost of the NMPC is due to the imposition of invariably very low IT. The theoretical insufficiencies of the NMPC, reviewed in section 2.1, foster the view that governments should put in place institutional mechanisms to ensure that inflation will be permanently very low or zero.

This is misguided, because excessively low and inflexible inflation targets can foster output volatility (as was shown in section 1.1.4), and they can lock the economy into a low-level equilibrium with low growth, high unemployment and intractable problems of poverty and inequality (see section 4.5). Moreover, permanently contractionary policies can also have negative distributive implications (see section 2.2.3), which is incompatible with MDGs and pro-poor objectives.

3.2 – The Cost of High Real Interest Rates

In the NMPC inflation control is achieved primarily through the manipulation of interest rates (see section 1.2). This implies that real interest rates tend to be higher under this policy regime than under an alternative regime in which other instruments play a more significant role in inflation control.

There is no question that higher interest rates can reduce inflation. They do so, first, because they increase the costs of production, investment and consumption,

and they may trigger government spending cuts because of the greater cost of the domestic public debt service. The weakening of demand tends to compress the profit margins in the competitive sector of the economy (the oligopolistic firms may be able to increase prices in order to defend their profits, but this will be ignored below for simplicity).

Higher financial costs may force highly leveraged or financially weaker firms into bankruptcy, regardless of their economic prospects, technical efficiency or strategic importance. The remaining firms could respond to these cost and demand pressures by reducing variable costs by inequitable and inefficient means. For example, they could find ways to reduce tax payments, increase the intensity of work or the unpaid working hours (in order to compel the employed workers to work for their dismissed colleagues), increase the turnover of labour (to hire cheaper workers), increase the degree of informalisation of the workforce (since informal workers tend to earn lower wages and lack social security and employment protection), and so on.

These economic changes will shift the structure of the economy. Finance will tend to gain (see below), and other shifts may affect the relationship between the tradable and non-tradable sectors, industry and agriculture, and the sub-sectors within them. The impact of higher interest rates cannot be anticipated in the abstract, because it depends on the initial structure of the economy, the response of the exchange rates, the pattern of demand, the responses of the export and import sectors, and other variables.

In this framework, it is possible that when growth finally resumes firms may attempt to restore their profit margins, possibly triggering an inflation bubble. Although this bubble would tend to blow itself over, it may trigger a knee-jerk response by the central bank through another round of interest rate increases. In this case, the recovery may be throttled, and the economy may be eventually locked into a low-growth, high-unemployment trap (see section 4.5).

Finally, macroeconomic policies are not distributionally neutral. Higher interest rates can transfer income in two ways, firstly from industrial profit to rentiers and, secondly, from workers to capital (see section 2.2.3). In their careful study of the distributional impact of high interest rates in the US and the UK between 1963 and 1997, Argitis and Pitelis identify both effects. They argue that higher interest rates increase production costs, transfer income from industrial capital to finance, and reduce the share of industrial capital in non-wage income. Later, the industrial capitalists may try to recoup their losses by raising prices, if the market conditions are favourable, or they may try to reduce unit wage costs by extracting more labour for the same wage (as was explained above). In order to offset its higher interest costs industrial capital will tend to demand more flexible labour markets (and, possibly, lower import barriers, since cheap imports can overwhelm labour resistance very effectively¹). If the industrial capitalists are successful, the non-wage income share will increase, while the workers' share will fall as a result of the higher interest rates.²

In the US and the UK (and elsewhere) higher interest rates were not imposed by market processes. Rather, they were introduced by governments as part of a macroeconomic management strategy. These policies contributed to a significant shift of the distribution of income towards non-wage income in general, and finance in particular:

The money lending interest rate appears to be the most important determinant of the industrial profit share ... Monetary policy ... [is] a channel through which intracapitalist distributional conflicts directly affect the distribution of non-wage income between industrial and financial capital. The implementation of a restrictive monetary policy ... will redistribute non-wage income in favour of the financial capital ... The

¹ See Argitis and Pitelis (2001, pp.625-6) and Saad-Filho (2005).

² Argitis and Pitelis (2001, pp.620-2).

opposite distributional effects will occur if monetary policy is expansionary.³

The imposition of these restrictive monetary policies is simultaneously a *reflex* of the growing power of finance, and it *fosters* the further increase of the power of this social group.⁴ However, both the concentration of power in the hands of finance and the concentration of income in the hands of the capitalist sector are inimical to pro-poor outcomes. If high interest rate policies systematically foster these outcomes, they should *not* play a prominent part in pro-poor economic strategies and, specifically, in pro-poor disinflation programmes.

3.3 – The Cost of Conflicts between IT and Balance of Payments Equilibrium

Open economies have more trouble pursuing IT, especially if they are poor (see section 4). This is because some of their policy instruments must be committed to maintaining a sustainable balance of payments position (unless they can print international currency, but this is the privilege of only a small number of nations), dealing with external shocks and contending with the additional channels linking policy variables and outcomes (for example, the employment effect of exchange rate changes).⁵

These economies are also unable to target both inflation and the exchange rate simultaneously, because an economy can have only one nominal anchor (see section 1.1.3). Having said this, IT is *also* incompatible with completely freely floating exchange rates, because they generate too much instability and can wreak

³ Argitis and Pitelis (2001, p.632); see also pp.626 and 628 and Rao (2002).

⁴ Argitis and Pitelis (2001, p.629).

⁵ 'Insofar as the additional exchange rate channel linking interest rates to inflation changes the structure of policy lags, openness also requires rethinking the relative weights on inflation and output in the [central bank's] reaction function. In general, the central bank of an open economy will respond less to inflation deviations relative to output deviations, since monetary policy, which also operates through the exchange rate, now has a more powerful, immediate effect on inflation' (Eichengreen 2002, p.20); see also p.41.

havoc on relative prices and on tight inflation targets.⁶ IT countries must therefore adopt managed (‘dirty’) floating exchange rate regimes:

A basic requirement for implementing an inflation targeting framework [is] the absence of implicit targeting of the exchange rate ... Adopting a low and stable inflation rate as the main objective of monetary policy requires in principle the absence of any commitment to a particular value of the exchange rate, as is the case under a floating exchange rate regime.⁷

The IT may conflict with the country’s balance of payments position at two levels. First, there may be conflicting demands on the interest rates (see section 3.2). In any small open economy with relatively developed currency and financial markets there is a close relationship between the following variables: the level of the interest rates, the inflation rate, the fiscal deficit, the unemployment rate, the exchange rate and the level and direction of the international capital flows. There is no guarantee that a single interest rate can control aggregate demand (and deliver IT), maintain a sustainable fiscal balance, clear the labour market, ensure exchange rate stability and deliver balance of payments equilibrium. Achieving these widely different goals requires a combination of policies in which the interest rates play an important but not necessarily decisive role.

Attributing unwarranted priority to the manipulation of interest rates in economic policy-making, as is the case in IT countries (see section 1.2) implies that these rates will tend to be determined by the higher of two possible levels: the interest

⁶ ‘Exchange rate ... volatility generates frequent revisions of inflation rate expectations and may result in non-fulfillment of inflation targets. As a general rule, the actions of the central bank should not move the exchange rate to artificial or unsustainable levels. However, the central bank may react to exchange rate movements to curb the resulting inflationary pressures’ (Minella et al 2002, p.25).

⁷ Agénor (2001, pp.4, 24). For this reason, ‘the central bank of Brazil ... has ... been implementing a dirty-floating exchange rate policy. Such interventions are made as transparent as possible in order to avoid the concern ... that intervention may hinder the credibility of monetary policy as the public may realize that stabilizing the exchange rate takes precedence over promoting price stability as a policy objective’ (Minella et al 2002, pp.25-6).

rates required to achieve IT, and those needed to close the balance of payments. If the latter is higher the exchange rate will be stable, but the economy will tend to become depressed through lack of demand. Unemployment will increase, inflation will decline to very low levels or move into negative territory, and the country could slide into a stabilisation trap (see section 4.5). Alternatively, if the former is higher there will be abundant inflows of foreign capital, especially if the capital account of the balance of payments has been liberalised, as is often the case in NMPC countries.⁸ These inflows could finance industrial development, or they could finance consumer goods imports to satisfy the solvent classes. They would also foster the revaluation of the exchange rate, potentially creating deflationary pressures. The increase in the country's external liabilities will be matched by the swelling of the domestic public debt, potentially exposing the economy to a financial crisis, a balance of payments crisis, a fiscal crisis, or all three of them.⁹ In sum, IT could generate additional output instability in an open economy.¹⁰

Second, it may be difficult to pursue IT if the private sector has large liabilities denominated in foreign currency (liability dollarisation, see section 4.2). In this case the financial institutions and their customers will be saddled with currency mismatches, which could be very costly should the exchange rate depreciate (especially if these exposures are not hedged). These mismatches will create demands for the central bank to maintain exchange rate stability, although this is ultimately incompatible with the IT regime (see above).¹¹ It is possible that, under these circumstances, inflation targeting may be wholly inappropriate, and a hard exchange rate peg may be more desirable, especially for very small economies. In this case the advantages of CBI would become purely academic.

⁸ See Eichengreen (2002, p.13) and Helleiner (1998).

⁹ See, *inter alia*, Arestis and Glickman (2002), Jomo (2001), Palma (1998) and Weller (2001). Several Latin American countries experienced periods of high interest rates for one or the other reason during the nineties; see Saad-Filho (2005).

¹⁰ Eichengreen (2002, p.14).

¹¹ Eichengreen (2002, pp.38-41).

3.4 – The Cost of the Central Bank’s Dual Mandate

The NMPC debate about dual or hierarchical mandates for the central bank (see section 1.3.4) is largely a red herring, since by definition inflation targeting implies that inflation control is the most important objective of economic policy. There is, however, *another* type of dual mandate for the central bank which is unavoidable, not always clearly recognised by the advocates of the NMPC, and which may carry considerable costs.

It was shown in sections 1.1-1.3 that the independent central bank is responsible for achieving IT. However, the central bank must also continue to be the bank of banks and the institution responsible for preserving the stability of the domestic financial system. These tasks cannot be delegated to another institution; they are necessarily part of the central bank’s remit.¹² In normal circumstances these two mandates are compatible, but they may conflict especially if the asset and product markets give contradictory signals about inflation, if asset prices are very volatile, or if asset prices rise rapidly as a proportion of GDP. For example, if price inflation threatens to escalate the central bank may be compelled to raise interest rates, which could undermine financial system stability and trigger a costly crisis.¹³ Alternatively, if deflation looms the central bank may be forced to lower interest rates, although this may fuel a destabilising bout of asset price inflation (i.e., excessively rapid increases in the prices of shares, bonds, houses or land) and a debt and consumption bubble based on loans secured on those rising asset prices.¹⁴

The close relationship between price inflation, personal and company debt, financial system stability and asset price inflation – especially when the

¹² See Lapavitsas (1997).

¹³ ‘To target price stability if that was in danger or bringing financial collapse would ... be a very narrow vision ... of monetary stability. It would certainly not be good policy’ (Forder 2003, p.15).

¹⁴ See Arestis and Sawyer (1998, 2005) and Toporowski (2000).

manipulation of interest rates becomes the most important instrument of economic policy – and the potentially huge cost of financial crises indicate that central banks ought to monitor asset prices and levels of debt *as part of their duty to maintain economic stability* (see section 5.1).¹⁵ In fact, the excessive focus of the NMPC on inflation control tends to distract attention from the financial sector as a major source of instability, which is misguided because the output and employment costs of financial crises can easily *exceed* any reasonable estimate of the cost of moderate inflation.¹⁶ In this sense, the NMPC offers poor guidance for monetary policy.

Most mainstream economists claim that it is impossible to monitor asset prices and debt levels and, even if this were possible, it should not be attempted for four reasons. First, because attempts to influence asset prices would interfere with the principles of the free market. However, complaints are never heard when the central bank must clean up the financial system, at public expense, after the crisis. Second, because it is allegedly impossible to know when asset price rises result from ‘speculative’ or ‘fundamental’ factors. This is true at the margin, but the curbs being discussed here concern only large deviations of the prices of financial assets from their historical pattern. It would be disingenuous to claim that trained economists are unable to spot price movements of this magnitude. Third, because loans are based on voluntary contracts and the state should not interfere in economic transactions between willing parties. This view is based on a partial assessment of the problem, because the debt bubble concerns not only individual choices but also their macroeconomic consequences, which are of concern to the monetary authorities. Fourth, and finally, because central bank attempts to prick an ongoing financial bubble may trigger a costly crisis. This is certainly possible, but the costs of financial instability and crisis at an even later stage would probably be even higher. In sum, there is no reason why central banks should fail

¹⁵ For estimates of the cost of financial crises, see World Bank (1989, ch.5).

¹⁶ See Rao (2002) for a similar argument.

to monitor asset prices and intervene in asset markets in order to preserve financial system stability.¹⁷

Excessive debt, asset price volatility and asset price inflation can be tackled in different ways. They include credit controls, the regulation of the issue and trading of financial assets, the demand for the disclosure of detailed information about the traded assets and their owners, and the imposition of capital gains taxes. These are not undue interferences with a smoothly functioning market. Rather, this is the *minimum* counterpart for the insurance services provided by the government to the owners of financial assets and the shareholders of the financial institutions.

3.5 – The Cost of Central Bank ‘Independence’

The NMPC claims that IT and CBI will boost the credibility of monetary policy and the transparency and accountability of the central bank, because the bank will be able to focus on clear and achievable goals and its performance will be accountable to the public. The democratic veneer of CBI is reinforced by the claim that ‘independence’ should refer to *instruments* rather than *goals* (see section 1.1.4).

The contrast between instrument and goal independence is not part of a serious debate about economic policy. ‘Goal independence’ is a caricature – a straw man invented to support the case for instrument independence. *No one* claims that the

¹⁷ For Agénor (2001, p.40), ‘the information contained in asset prices movements may be limited because they may reflect erratic changes in expectations. To what extent this is actually the case may be difficult to gauge, because existing asset price models are based on unobserved variables; their empirical predictions are subject to wide margins of error. This makes it difficult to identify the “right” price (reflecting, say, future profit growth rates or productivity shocks) and therefore what is an erratic movement or speculative bubble. In such conditions, incorporating asset prices systematically in monetary policy feedback rules may be unwarranted. Moreover, the risk premium that is typically embedded in asset prices tends to vary over time. Basing monetary policy on a broader, asset-based measure of prices or monetary conditions may actually lead to greater variability in current and future output and inflation.’

central bank should be able to choose its own targets, instruments and policy horizons, and pursue them at public expense.

Let us then focus on the more serious matter of instrument independence. The case for instrument independence was outlined in sections 1.1.3, 1.1.4 and 1.3. This case hinges on the credibility, transparency and accountability of monetary policy. These arguments are inconsistent, disingenuous and politically and financially costly for five reasons.

First, arguments for CBI are based on the presumably greater transparency, legitimacy and accountability of monetary policy under this institutional arrangement. However, this claim veils the greater scope for *discretion* in the conduct of monetary policy under CBI. In this policy regime the board of the central bank becomes free to consult ‘the markets’ and select among a broad range of possible levels of interest rates, among other policy instruments. In contrast, in previous monetary policy regimes claims for higher interest rates, for example, would have to be argued politically at several levels of government, especially at the Ministry of Finance. There, counter-claims expressing the interests of different social groups could (at least in principle) be heard, and there might have been scope for reaching a balanced decision (see section 5.3). In other words, anti-inflation policies ought to be determined through a reasonable assessment of the social and economic costs of inflation, their distributive implications, and the distribution of the gains of stabilisation. This debate should be *welcomed* for how ‘could it be thought reprehensible for the elected representatives of the people to seek to influence – by persuasive argument perhaps – the central aspects of [economic] policy?’¹⁸

¹⁸ Forder (n.d.).

Therefore, CBI is *undemocratic* because the insulation of monetary policy from public debate *reduces* the accountability of the central bank to the public, and *curtails* the democratic legitimacy of monetary policy:

It is apparent, then, that the advocates of independence have settled on a notion of ‘accountability’ which misses the essential point and is inadequate to the task of establishing the democratic legitimacy of independent central banking. Placing an obligation to ‘explain’ on agencies is not a means by which the demos governs.¹⁹

Second, greater central bank ‘credibility’ and ‘reputation’ are misnomers. The improved indicators of credibility that usually follow CBI are not due to higher values being generated by impartial econometric models. ‘Expectations’ are the sentiments of a relatively narrow circle of individuals in positions of power, and whose material interests are directly affected by the choice of government policy. In this case, ‘improved expectations’ are simply a reflection of the closer institutional relationship between the central bank and the financial markets under CBI, the financial operators’ appreciation of the central banks’ performance, and their confidence that monetary policy will continue to be determined by their narrow interests in the future. ‘Credibility’ measures the *takeover* of monetary policy by the financial interests (see below).²⁰ In spite of these limitations, government behaviour can influence the existing measures of credibility in a more constructive way. Consistent policies that are initially ‘not credible’ (that is, not conducive to the short-term objectives of the financial markets) can gain

¹⁹ Forder (2003, p.41). This article includes a comprehensive review of the inconsistencies in CBI and the case for economic democracy. See also Epstein and Yeldan (2004).

²⁰ ‘What does one make, for example, of the remark of former Bundesbank president Blessing ... that a central bank “has to be independent because one cannot really trust the politicians – they are all a rotten lot and any of them might seek to get out of a hole by printing money”?’ One wonders what Mr Blessing would have trusted to politics’ (Forder 2003, p.3n1).

credibility if they are implemented firmly and purposefully, and if they achieve results that are not wholly incompatible with the long-term interests of finance.²¹

Third, the central bank is presumably different from other public sector institutions because of the supposed neutrality of its objectives and the technical difficulty of implementing the ‘optimal’ monetary policy.²² From a mainstream perspective, most public institutions allocate limited budgets among competing priorities, and their choices should be scrutinised by the voters regularly. In contrast, the central bank does not have real choices to make, and its routine operations should normally be insulated from ‘unwarranted’ pressures from sub-national governments, politicians, trade unions, civil society organisations and social movements, in order to avoid ‘politicising’ monetary policy decisions and risking the credibility of the ITR. This argument is inconsistent. The management of the tax system, the rail network, the electricity grid and the government’s housing programme are just as complex as the implementation of sound monetary policies.²³ All of them have significant distributive implications, and they involve a combination of technical knowledge and political choices – in fact, just like the administration of large private firms. The difference between them, trivially, is

²¹ The success of the initially much-derided Malaysian capital controls in the early eighties is only one example of how governments can transform financial market expectations; see Epstein, Gabel and Jomo (2003) and Kaplan and Rodrik (2000). See also Sicsú (2001).

²² ‘The remarkable degree of isolation of the European central bank from democratic control is called ‘independence’, it is emphasised by its advocates that complete protection from political control is necessary to its successful operation, and it is said that this is desirable because monetary policy is a purely technical matter involving no value judgements; politicians in control will set it for electoral ends; and independence will improve credibility’ (Forder 2003, p.42).

²³ ‘Blinder ... is unusually explicit amongst the advocates of [central bank] independence in making the case in terms of the absence of normative issues. He specifically draws attention to the fact that the details of tax policy are no less complex than the operation of monetary policy, but argues that they are properly kept under Congressional control because they have significant distributive effects. Monetary policy, on the other hand, he says, lacks these effects, and therefore the fact that it is difficult argues for the removal of direct control of it from politicians ... Although the claim that monetary policy involves only technical matters does not acknowledge the view that democracy has intrinsic value, it also suffers other, perhaps more important internal weaknesses. First, there is doubt as to the value of the natural rate theory itself. Secondly even if it is the case that monetary policy has no lasting effect on employment, it does not follow that it has no temporary effect that should be the concern of policy. Thirdly, it is erroneous to deduce from the non-existence of monetary effects on employment that monetary policy has no effects on any policy objective other than inflation’ (Forder 2003, p.11).

that incorrect decisions by private firms are punished financially, while government policy decisions must be open to public scrutiny through the democratic process.

Fourth, advocates of CBI implicitly argue that the central bank should become simply a machine that performs reliably a specific task. The bank should mechanically (and ‘transparently’) manipulate a given set of instruments, especially the interest rates, in order to deliver the inflation targets set by the government. In this case central bank policies can be assessed only through their efficacy, and studies of IT never forget to mention that the Governor of the central bank of New Zealand can be dismissed if s/he fails to achieve the IT.²⁴ This argument is incorrect. On the one hand, it presumes that the central bank can deliver (something approaching to) the inflation targets if it *really* wants to. This is merely a revamped version of the monetarist claim that money supply targeting is feasible and sufficient to control the rate of inflation, which was proven to be wrong many years ago (see section 2.1).²⁵ On the other hand, it ignores the real dilemmas involved in central bank policy, especially the potential conflicts between monetary and financial stability (see sections 3.3 and 3.4).

Finally, it is odd that the IMF should insist so heavily on the advantages of CBI when the Fund itself is anything but ‘independent’. The members of the Fund’s board of governors and executive board are appointed politically, through a process that is anything but transparent or accountable, they have no significant autonomy. Their decisions are normally strictly guided by the interests of its large member countries, especially the United States.

²⁴ For a detailed study, see Mayes (1998) and Mayes and Razzak (1998).

²⁵ See Lapavitsas (1997, p.26n16).

3.6 – The Costs of Agency Capture and Financial Bias

The arguments outlined in the previous section point to the fact that CBI implicitly *promotes* agency capture. The term ‘agency capture’ is used to explain the convergence of interests between the regulator and the regulated sector, potentially leading to the takeover of the former by the latter. Regulated sectors always find it worthwhile to lobby the regulator because of its enormous influence over the health of the sector and the distribution of benefits within it. At the same time, the regulator tends to become identified with the health of ‘its’ sector. Contacts and professional specialisation ensure that there will be a continuous exchange of personnel between them and, if the regulator is insulated from public scrutiny, its capture by the private sector is facilitated – in extreme cases, the regulated eventually regulate the regulator at the expense of the public interest.²⁶

The interaction between the central bank and the financial sector is especially prone to agency capture. They must always work closely together, because of the central bank’s duty to manage the monetary system and ensure financial system stability. The technical expertise required by central bank activities narrows the pool of potential recruits to novices, that must be trained by the experts, academic specialists in finance, who are usually committed to mainstream views, and financial market operators, who tend to return to greener pastures at the end of their (usually brief) stint in the public sector:

[C]entral bankers are typically chosen from conservative elements of the financial community. One incentive that the head of the central bank might have for holding down inflation is that he can thereby improve his standing in the financial community, and thus earn greater remuneration upon returning to the private sector.²⁷

²⁶ Arestis and Sawyer (1998a).

²⁷ Rogoff (1985, pp.1179-80).

Similarly, for Stiglitz,

In many countries bankers are disproportionately represented [among central bank staff], and even if they do not come from a banking background, they quickly get captured by the banking community in which they are immersed. Few countries ensure that workers and their interests are represented, even though the actions of the central bank have a vital impact on them.²⁸

Given their material and ideological interests, it is unsurprising that central bank staff tend to share the financial market's understanding of the 'needs' of the economy. In effect, CBI tends to make the central bank even closer to the financial community than was legally and politically feasible before. This objective is clearly acknowledged by the advocates of the NMPC:

It is harder for the central bank to 'cheat' on its mandate when it is forced to lay out an internally consistent basis for the decisions to be made. To be sure, a good publicist can make almost any position sound reasonable, *but when it matters financial markets seem to have good noses for spin-doctoring.*²⁹

This statement indicates that the financial markets should be entrusted with the role of judging public policy, which they will be very happy to do in their own benefit. Alternatively, and this time more subtly:

Because a short-term interest rate *can be monitored by the public* on a real-time basis and is easy to understand, it is usually a more transparent

²⁸ Cited by Patrício (2002).

²⁹ Agénor (2001, p.27), emphasis added.

operating guide than one defined in terms of base money or a monetary conditions index. Any changes in the stance of monetary policy should be communicated immediately *to the public*.³⁰

There are no prizes for guessing which members of ‘the public’ monitor short-term interest rates on a real-time basis, and who should be informed first of any change in the stance of monetary policy.

CBI is not simply a technically ‘neutral’ response to objective economic constraints. It entrenches new constraints upon social and economic behaviour by reconstituting the relationship between the financial sector and public policy. For example, the executive’s right to dismiss the board of the central bank can be an important counterweight to the hegemony of the financial interests. The removal of this prerogative makes it harder to ensure that the bank responds to the demands of the majority. Under CBI, nominally independent central banks are *meant* to serve primarily the interests of the financial sector through the institutionalisation of the role of ‘credibility’ and ‘expectations’ in monetary policy-making. The economy develops a *financial bias*.³¹ This is the culmination of agency capture.³²

Under CBI the financial markets are increasingly able to determine the economy’s long-term prospects. Their influence becomes decisive for the intersectoral allocation of resources, the level and composition of output, the distribution of income, the composition of investment and the stability of the balance of

³⁰ Carare et al (2002, p.8), emphases added.

³¹ This term is used, in another context, by Bresser-Pereira and Nakano (2003).

³² ‘Posen ... suggests that consistent counter-inflationary policy is maintained *only where the financial sector has the political power to protect the central bank from other interest groups*. In this way, he is able to explain both independence and low inflation with a measure of financial sector power. But it is also evident from this view that independent central banks are construed as serving the interests of their clients in a certain section of society. If that is the case, then there is clearly an important issue about the democratic legitimacy of the arrangements ... [I]t is difficult to see where the advocates of independence have responded to such a concern’ (Forder 2003, pp.28-9), emphasis added.

payments. This increasing influence is not counterbalanced by accountability. Although the financial sector is regulated by the central bank (which it has already captured), it is accountable only to a small number of partners and shareholders who, in all likelihood, are not committed to pro-poor objectives or MDGs (see section 5). It is very difficult to find a democratic rationale for this arrangement.³³

CBI can therefore be explained by *agency capture* and by the attempt to *institutionalise* the economy's financial bias.³⁴ Therefore, central bank performance contracts, inflation targets, inflation reports and other monitoring devices are little more than diversions – instruments facilitating (indeed, *ensuring*) the delivery of financial market goals by a public sector agency, at a cost borne by society as a whole:

To date, there is no evidence that insulating policy from the political process improves economic performance in any significant respect. But there is overwhelming evidence that this strategy imposes severe costs on the economy and especially on the most vulnerable segments of society. This finding contradicts the neoliberal view that independent policymaking institutions are neutral guardians of the national interest. These institutions typically meet the needs of investors, lenders and business interests rather than serve the public good.³⁵

The institutional rigidity imposed by CBI and IT can be interpreted as part of an attempt to secure agency capture and the reproduction of financial bias. It would be unwise for governments aiming to achieve pro-poor objectives to adopt NMPC policies, and doubly so to entrench them into an excessively rigid monetary policy framework. This is not only because this would make it harder to change policies

³³ 'Placing policymaking authority in the hands of un-elected technocrats runs counter to principles of democracy, accountability and transparency. Moreover, this strategy does not even improve long-term economic performance' (Chang and Grabel 2004, p.49).

³⁴ For a similar analysis applied to the Korean case, see Chang (2000).

³⁵ Chang and Grabel (2004, p.51).

that do not serve the interests of the majority. It is also because it is *always* best to preserve monetary policy flexibility. Inflation is determined by shifting combinations of complex factors (see section 2.1), and institutional rigidity is hardly the most efficient way to tackle changing economic problems. CBI and IT will lock into place the theory of inflation and the anti-inflation policies that are currently fashionable, and that serve primarily the interests of the financial sector.³⁶ These rigidities are bound to create unnecessary costs and political difficulties in the future, as the causes of inflation change or when shifts in the correlation of social forces permits the implementation of pro-poor anti-inflation policies (see section 5.3). Finally, the insulation of monetary policy from public scrutiny and government control may thwart the co-ordination of policies that is essential for the success of *any* broad-ranging government initiative. It is much harder to deliver the outcomes chosen by the electorate if the government can count on only one set of (fiscal) instruments, while monetary policy may be pursuing entirely different targets – which may even compromise the achievement of other desirable objectives.

But why should the politicians consent to this extensive erosion of their power? The answer is that CBI and IT may be functional for many politicians because they externalise three important problems – the level of interest rates, the relationship between finance and the productive sector and the level and structure of output and employment. It can also improve their credibility with the ‘international community’. This process of externalisation can be politically expedient (as well as personally advantageous) because it obviates the need for politicians to defend unpopular (neoliberal) policies, and it locks in these policies regardless of the wishes of the electorate. Economic policy becomes unchangeable, and it is effectively excluded from political debate.

³⁶ ‘[E]conomic theory is so subject to change that a long-term commitment to a certain approach to policy is a dangerous thing’ (Charles Goodhard, cited in Forder 2003, p.12).

This section has shown that, in spite of its shortcomings and inconsistencies, the NMPC is functional for the financial system and for many politicians. It transfers power from the state to finance, excludes inconvenient political dilemmas from public scrutiny, and helps to consolidate a specific form of minority power through a veil of ‘neutrality’ and ‘objectivity’. This massive redistribution of power and income is validated by a slick discourse, perfected over many years in academia, in journalistic outlets and in political circles. CBI and IT are not isolated political choices, and they are not determined from without (presumably from a disembodied ‘global economy’). They are part of a process of institutional reorganisation that seeks to capture policy-making capacity and state resources and legitimacy, in order to promote financial market interests dressed up as the general good. Mainstream economics provides an essential element for this emerging consensus – academic credibility – and it lends depth and density to the ruling discourse.

The NMPC will not go away easily, because it is part of, and promotes, a stable institutional arrangement. Its imposition in country after country triggers material and institutional changes that reinforce and validate the dominance of financial interests. Challenges to the NMPC must be, correspondingly, multilayered, including the academic, political, ideological and institutional levels. In this confrontation, pro-poor policies and MDGs offer the best possible platform for the critics of the ruling policy compact (see section 5).

4 – The NMPC and the Developing Countries

This section reviews the implications of the NMPC for the poor countries. In recent years several middle-income countries have implemented ITR,¹ often in response to unsustainable pressures on their fixed or adjustable peg exchange rate regimes.² The NMPC offers these countries not only an alternative nominal anchor, but also a ready-made policy framework that can – at least in principle – deliver the best of both worlds:

[I]n a world of high capital mobility and unstable capital movements, conventional pegged exchange rates have proved fragile ... [R]ecent experiences suggest that exchange rate pegs can be sustainable only when they are credible, and credibility is to a large extent determined by domestic macroeconomic policies ... [T]he adoption of inflation targeting may lead to a more stable currency if it signals a clear commitment to macroeconomic stability and a freely-floating exchange rate.³

In spite of these reassuring promises, the NMPC places heavy demands on the developing countries. These demands help to explain why no poor country has, thus far, been either able or willing to adopt inflation targeting. These demands can be grouped into four areas: fiscal, balance of payments, financial and institutional constraints. They are considered below.

4.1 – The Fiscal Constraint

It was shown in section 1.1.3 that IT is incompatible with fiscal dominance; in other words, fiscal constraints cannot determine the choice of macroeconomic

¹ For example, the Czech Republic and Israel in 1998; Brazil, Chile and Poland in 1999; Hungary, Mexico, South Africa and Thailand in 2000; Colombia and South Korea in 2001, and Peru and the Philippines in 2002.

² See Agénor (2001, pp.3-4).

³ Agénor (2001, p.21).

policy. Many developing countries will find it difficult to satisfy this requirement because their fiscal institutions tend to be weak. These countries are poor, their tax system tends to be inefficient and, consequently, their tax ratios tend to be low. Many governments find it impossible to fund their expenditures through taxation, and the financial system tends to be too shallow to allow these deficits to be covered through borrowing. Seignorage is therefore important for many governments. However,

Reliance on seignorage is perhaps the simplest and most common indication of fiscal dominance ... in a large number of developing countries, fiscal dominance and a poor financial market infrastructure severely constrain the scope for independent monetary policy.⁴

Appropriate solutions will need to be found, taking into account this structural feature of the fiscal system of most poor countries.

4.2 – The Balance of Payments Constraint

The balance of payments constraint influences developing country monetary policy choices at three levels: vulnerability to crisis, vulnerability to exchange rate movements, and vulnerability to balance sheet disorders.

4.2.1 – Vulnerability to Crisis

The risk of balance of payments crisis is much higher in developing countries than in rich countries. These countries are economically small, their currencies are weak, and their economies tend to be highly vulnerable to externally induced disturbances. Very poor countries are often confronted with a structural scarcity of foreign exchange that grinds down their growth prospects and compels these

⁴ DeBelle et al (1998).

economies to underperform for long periods. In contrast, the middle-income countries are the ‘customers of last resort’ of the international financial markets:

[N]o matter how much liquidity international financial markets have on offer, their operators can always solve the problem of “market clearing” by loosening their quantity restrictions to LDCs. However, this process has proved to be an inefficient mechanism for allocating financial resources since it has led to the accumulation of risk at levels that are not privately efficient, let alone socially efficient.⁵

The middle-income countries have an insatiable demand for foreign currency at any level of interest rates. Their economies tend to perform well when funds are abundant;⁶ however, when market conditions turn to the worst – and they can do so very rapidly (‘sudden stops’) – these countries can face devastating balance of payments crises.⁷ The crisis eliminates any possibility of inflation targeting possibly for a long time, because of its overwhelming implications for inflation, interest rate policy, the fiscal balance, the financial system, the rate of unemployment and the country’s pattern of trade.⁸ More generally, the possibility of ‘sudden stops’ and balance of payments crisis creates uncertainty and economic instability which may reduce the credibility of the IT regime and jeopardise the fulfilment of the targets.⁹

⁵ Palma (1998, p.791).

⁶ See Calvo et al (1993).

⁷ For example, in 2002 Brazil was faced with a negative swing in capital flows of US\$ 30 billion (6 per cent of GDP), relative to an already difficult 2001. This ‘sudden stop’ led to a nominal exchange rate depreciation of 50 per cent; see Fraga et al (2003, p.5) and Saad-Filho (2003). See also Helleiner (1998) and Kaminsky and Reinhart (1999).

⁸ Other types of adverse shock can also compromise an inflation targeting regime; see, for example, Rogoff (1985, pp.1186-7).

⁹ See Fraga et al (2003, pp.24-25) and Mishkin (2004, pp.3, 5).

4.2.2 – Vulnerability to Exchange Rate Movements

Developing country currencies tend to be relatively volatile, regardless of balance of payments crises.¹⁰ The impact of exchange rate movements also tends to be passed through into domestic prices more rapidly in developing countries than in the rich countries because of indexation or currency substitution. This rapid pass-through tends to consolidate otherwise transitory depreciations into a permanently lower exchange rate, making it more difficult to maintain price stability.¹¹

The central bank may be tempted to respond either by raising interest rates in response to even minor currency devaluations, or by intervening in the foreign exchange market to limit currency fluctuations ('fear of floating'). Both types of intervention would probably be successful most of the time. However, they could occasionally trigger conflicts between IT and balance of payments equilibrium (see section 3.3).

4.2.3 – Vulnerability to Balance Sheet Disorders

In poor and middle-income countries currency substitution tends to be much more frequent than in the rich countries because of ingrained economic instability, generalised distrust of the local currency, and the currency's marginal role in international exchanges. Balance sheet disorders are much more likely to occur in this type of monetary system.

In the rich countries a currency devaluation does not tend to affect the balance sheets of households, firms, banks or the state because their debts are generally denominated in domestic currency (and, in the case of banks and the state, these debts are normally hedged). This is not the case in several developing countries.

¹⁰ See, for example, Fraga et al (2003, pp.25, 27).

¹¹ See Eichengreen (2002, p.21).

In these countries many domestic agents have debts denominated in foreign currency. In this case, a large currency devaluation creates a mismatch between the value of their assets (denominated in devalued domestic currency) and liabilities (denominated in foreign currency) that can increase significantly their debt burden. The deterioration of their balance sheets can create hardship for the households, bankruptcies among firms, and it can trigger a fiscal and financial crisis. The banks tend to respond to the crisis by contracting their lending operations, which exacerbates everybody else's problems and may even induce a full-scale depression, especially if the state fails to reflate the economy promptly (at the risk of triggering a severe bout of inflation).¹²

In other words, the central bank's objective function *must* include the stabilisation of the exchange rate, because the cost of 'benign neglect' can be devastating. For countries in this situation IT may be an entirely misguided objective for, if the central bank attempts to reduce the economy's vulnerability, it will find it impossible to focus primarily on achieving the IT. This is especially true in periods of turbulence, i.e., precisely when a nominal anchor would be most useful.

4.3 – The Financial Constraint

The financial system of developing countries tends to be fragile when compared to the rich countries.¹³ This is partly a reflex of their short-termism and lack of depth, partly a result of the severity of the fiscal constraint in these countries (see section 4.1), partly the outcome of financial liberalisation¹⁴ and partly due to their greater balance of payments vulnerability (see section 4.2).

¹² The Argentine crisis of 2001 is the most dramatic example of this sequence of events in recent times; see Calcagno (1997), Halevi (2002) and Rozenwurcel and Bleger (1998). However, similar processes were observed in Chile, in 1982, Mexico, in 1994-95, East Asia in 1997-98 and Turkey in 2001; see Agénor (2001, pp.24-5) and Mishkin (1998, pp.7-8).

¹³ Fraga et al (2003, p.25).

¹⁴ 'The record of financial liberalisation has been neither pro-poor nor pro-growth. It often destabilised the economy and denied access of poor people to credit. Real interest rates have tended to rise and the spread between the deposit and lending rates has widened – both

The relative lack of long-term financial assets in the developing countries, and their lower ratios of liquid liabilities to GDP and private credit to GDP reduce the effectiveness of the monetary transmission mechanism, making it less reliable for policy purposes. Because of these weaknesses, short-term interest rates have to move more quickly and sharply, which can be tricky because developing country central banks tend to be less able to manage monetary policy efficiently, and their financial systems are less able to absorb such shocks. The inevitable consequences are higher interest rate volatility and greater financial fragility in these countries.¹⁵

Financial fragility implies that the central bank must focus on financial system stability much more closely than in the rich countries (see sections 3.4 and 4.2). This constraint implies that the central bank is unable to focus primarily on achieving the IT through interest rate manipulation; it also means that the ITR is less credible because the financial markets *know* their own vulnerabilities. Therefore, the market operators have strong reasons to doubt the commitment of the monetary authorities:

Faced with a weak banking system ill prepared to absorb interest rate increases, which raise the cost of servicing its short-term liabilities and increase default rates by borrowers, [the central bank] may want to limit interest-rate volatility and administer its anti-inflationary medicine in small doses. But if the monetary authorities fail to respond quickly when inflation heats up, observers may begin to wonder whether they are optimally trading off objectives or they are in fact not really committed to price stability.¹⁶

undercutting jobs and growth. Farm and non-farm enterprises often lost access to credit as banks focused on short-term lending for consumer durables in urban areas' (Vandemoortele 2004, p.14).

¹⁵ See Fraga et al (2003, p.24).

¹⁶ Eichengreen (2002, p.36).

4.4 – The Institutional Constraint

Developing countries lack several institutional requisites for inflation targeting. In order to set up a successful ITR,

the authorities ... have to take certain preliminary steps. They must establish explicit *quantitative targets* for inflation for some periods ahead. They must indicate clearly and unambiguously to the public that hitting the inflation target takes precedence over all other objectives of monetary policy. They must set up a model or methodology for *inflation forecasting* that uses a number of indicators containing information on future inflation. Finally, they must devise a *forward-looking* operating procedure in which monetary policy instruments are adjusted (in line with the assessment of future inflation) to hit the chosen target. The monetary authorities must have the technical and institutional capacity to model and forecast domestic inflation, know something of the time lag between the adjustment of the monetary instruments and their effect on the inflation rate, and have a well-informed view of the relative effectiveness of the various instruments of monetary policy at their disposal.¹⁷

This is a very tall order for most developing countries.¹⁸ The countries that would presumably benefit most from IT lack a strong history of low inflation and of successful anti-inflation policies. Their central banks lack the institutional capability to monitor prices and real and financial sector developments

¹⁷ Debelle et al (1998).

¹⁸ The proponents of the NMPC are prepared to be flexible: 'such requirements should not be overstated; forecasting capability, for instance, can never be perfect and sensible projections always involve qualitative judgement. A more important and difficult task, in many cases, may be to design or improve the institutional framework in order to allow the central bank an effective degree of independence in pursuing the goal of low and stable inflation without undue pressure to stabilize output fluctuations or alleviate the public debt burden through low interest rates' (Agénor 2001, pp.65-6). In other words, governments can presumably circumvent the lack of the basic conditions for IT purely administratively, by giving the central bank *more independence!*

adequately. They may lack a minimally sophisticated model of the economy, and the monetary transmission process in particular, among many other shortcomings.

These difficulties inevitably compromise the ‘credibility’ of the monetary authorities. If they are nevertheless determined to press ahead with IT, the central bank will be *forced* to impose more stringent policies than would be the case in other countries, in order to reap credibility gains in the future, which will eventually allow the bank to relax its policy stance:

[T]he central bank incurs a cost of trust building as it has to react to curb the inflationary pressures stemming from low credibility and has to ‘prove’ that is committed to the new regime. During some period, the volatility of interest rate and output will be higher, and, since the central bank also takes into account output costs, the inflation volatility also tends to be higher when compared to a situation of full credibility ... [However] later on [the economy] benefits from an improved trade-off with lower output and inflation variability, and the central bank can then be a more flexible inflation targeter.¹⁹

It is even harder if the ITR is adopted in an economy with an inflation rate much higher than the long-term goal. In this case,

the central bank has to conduct an active policy with output costs to bring inflation down. The reduction in inflation faces two obstacles, which result in costly disinflation and higher volatility of inflation and output: ... imperfect credibility, and ... inflation persistence, resulting from some backward-looking behaviour in price setting. The presence of backward-

¹⁹ Fraga et al (2003, pp.14, 18).

looking behaviour may be due to factors such as indexed wage contracts, and adaptive expectations.²⁰

The advocates of the NMPC acknowledge the existence of a vicious circle between, on the one hand, low credibility and relatively fragile institutions and, on the other hand, fiscal and financial fragility, macroeconomic instability and higher vulnerability to external shocks.²¹ However, they claim that this vicious circle can be broken through the establishment of the *credibility* of the monetary authorities.²² In this case, the economy would gradually converge towards a good equilibrium with high monetary policy credibility, low and stable inflation, and greater financial and balance of payments stability.

This is certainly possible, and there is no question that important successes have been achieved in several inflation targeting middle-income countries recently. However, the structural economic problems of the developing countries, outlined above, cannot be simply wished away or addressed purely through subjective manoeuvres.²³ Fiscal, balance of payments and financial instability and institutional weaknesses are not simply due to subjective deficiencies in ‘credibility’. They are *features* of poverty and underdevelopment. The questions,

²⁰ Fraga et al (2003, p.17).

²¹ ‘Absent confidence that the central bank is committed to low inflation, interest rates will not fall to the levels of other low-inflation countries. Shocks will raise questions about whether the authorities are prepared to stay the course. Sharp changes in interest rates, exchange rates and international capital flows may feed upon themselves: financial variables will be volatile, with negative implications for the economy. If policy is not credible, then firms will not reduce price increases to meet the inflation target. Hitting it will require an increase in interest rates sufficient to deliver a substantial reduction in import prices (through a sharp appreciation of the exchange rate), with destabilizing output effects’ (Eichengreen 2002, p.35).

²² See Eichengreen (2002, p.38) and Fraga et al (2003, p.4).

²³ For example, it is insufficient to state that the emerging market countries face ‘more acute trade-offs – higher output and inflation volatility – and worse performance than developed economies. These results stem from more pronounced external shocks, lower credibility, and lower level of development of institutions in these countries. In order to improve their performance, we recommend *high levels of transparency and communication with the public* and the *development of more stable institutions*’ (Fraga et al 2003, p.3, emphasis added). This is a wish-list rather than a set of sensible policy recommendations, which is surprising coming from the central bank president that introduced IT in Brazil.

then, are the cost of addressing these shortcomings, the expected success, and whether there may be a more socially productive use for these resources.

4.5 – Stabilisation Traps

The previous sections have argued that inflation and inflation control through CBI and IT can be costly. These costs should be compared and contrasted across different types of stabilisation policy in order to inform pro-poor policy choices (see section 5). Section 2 and Box 3 have also shown that inflation has declined to its lowest level since the sixties in many countries. In spite of this, GDP growth rates have failed to pick up and, in fact, they have continued to fall almost everywhere, while unemployment has tended to increase in many countries. These trends lend credence to the claim that there is no stable trade-off between inflation, growth and unemployment (see section 2.2.1). The relationship between these variables depends on the circumstances of time and place, and it cannot be generalised.

Persistently falling inflation and growth and rising unemployment can be dangerous, because they can trigger a *stabilisation trap*.²⁴ The implementation of persistently contractionary policies in order to achieve very low inflation (whether or not through ITR) can lock the economy into a perverse equilibrium with very low inflation, low growth rates and high unemployment. Stabilisation traps can also induce a deterioration of the distribution of income either directly (because of the job losses and the greater rewards to finance through high interest rates), or they may do so indirectly (because the economic stagnation reduces the resources available for poverty reduction policies).

The NMPC can be conducive to stabilisation traps because of its obsession with achieving very low rates of inflation. The IT is secured through the manipulation

²⁴ See McKinley (2003).

of the output gap by changes in the nominal interest rates. If every time that aggregate demand increases and some prices rise, perhaps to compensate previous losses (see section 3.2), the central bank raises interest rates because of its ‘fear of inflation’, the bank will be hampering relative price changes. This will make it harder for the price system to signal consumer preferences and resource scarcity (as well as economic power). An obsession with very low inflation will therefore increase relative price rigidity, impeding the economy’s adjustment to real shocks, making it more costly to introduce technical innovations, and systematically choking growth.²⁵ In this sense, a little inflation *can* help to ‘grease’ the economy.

If investment is sensitive to the interest rates, as is normally expected, and to the output gap (i.e., if, all else constant, there is less investment when unused capacity is high), very low IT will hamper not only *current* GDP growth but also depress investment and the growth rate of the capital stock. The cumulative reduction of investment and growth will reduce the economy’s potential output over time, leading to persistent economic underperformance *in spite of the full utilisation of the existing capital stock*.

In other words, the economy will adjust to persistently contractionary economic policy through a downward shift of the path of potential output (lower growth rate of capacity), so that the existing capacity will tend to be occupied earlier (it is therefore impossible to diagnose a stabilisation trap simply through the rate of capacity utilisation). The declining growth rate of the capital stock will, in turn, raise the rate of unemployment and underemployment, at least until emigration or the demographic transition catch up with the economic transition. This stabilisation trap will also reduce the economy’s capacity to accommodate high growth rates in the future, because inflation and balance of payments pressures will become binding at lower GDP growth rates. Rao (2002) hints at this exact same problem when he argues that:

²⁵ See Ghosh and Phillips (1998, p.673).

[E]xcessive fiscal deficit reduction and monetary restraint causes growth to be policy-constrained i.e., growth is demand-constrained but demand is itself policy-constrained. Thus, orthodox stabilization aims to promote growth with stability but ends up compressing investment.²⁶

This is especially problematic for the very low income countries, because a stabilisation trap will make it much harder to address their urgent problems of poverty and insufficient levels of human development.

The stabilisation traps suggest that the neutrality of money, which is essential for the mainstream theory of inflation, is incorrect: monetary variables (and monetary policy) *can* affect the long-term trajectory of the economy. At a more practical level, they also suggest that the costs of IT could *exceed* the costs of moderate inflation in the long-run (see section 2.2.2). Finally, stabilisation traps facilitate the onset of deflation, which may be triggered by negative demand shocks or balance of payments crises (see sections 3.3 and 4.2). In this case, a stabilisation trap would lead into a self-reinforcing downward spiral of prices, profits, output, incomes and profit expectations, as well as continuous capital flight, from which it could be difficult to extricate the economy.

²⁶ ‘A price constrained economy can be defined as one that is either in a unique full employment general equilibrium, or prevented from achieving that general equilibrium by private or public price ‘distortions’. An economy is demand constrained when its level of output is limited by one or all of the components of aggregate demand: consumption, private investment, government expenditure, or exports’ (Weeks 2003).

5 – Pro-Poor Monetary Policy Alternatives

It has become clear that most countries are unlikely to realise their MDGs. Mainstream (Washington consensus) policies have unquestionably failed to achieve their stated aims, and the search for alternative development strategies has become urgent. UNDP has offered an important contribution to the development of an alternative pro-poor policy agenda and pro-poor macroeconomic policies. This section reviews this contribution, and outlines pro-poor policy alternatives to the NMPC.

This section includes three parts. The first briefly summarises selected principles of pro-poor macroeconomic policies.¹ The second reviews some of these policies for illustration purposes, and in order to demonstrate their internal consistency. These policies can be distinguished from mainstream or Washington consensus policies on several counts. The most important differences are their direct and unmediated focus on achieving MDGs, and their emphasis on growth, distribution and the improvement of the welfare of the poor. In contrast, Washington consensus policies claim that low inflation, balance of payments equilibrium and investors' 'confidence' are the keys for rapid and stable growth, and that the latter will spontaneously lead to gains for the poor.² This approach has been unsuccessful almost everywhere. The disappointing record of mainstream policies, the declining growth rates in the world during the last three decades (see Box 2) and the deterioration of the distribution of income in most countries, and in the world economy as a whole,³ lend urgency to identifying pro-poor policy

¹ For an overview of this rapidly expanding literature, see Dagdeviren et al (2002), Kakwani (2001, 2002), Kakwani and Pernia (2000), MacEwan (1999), McCulloch and Baulch (1999), McKinley (2001, 2003, 2004), Osmani (2001), Palanivel (2003), Palley (2000), Pasha and Palanivel (2004), Rao (2002), Solimano (1999), UNDP (2002), Vandemoortele (2004) and Winters (2002).

² See, for example, Sahay, Cashin and Mauro (2001).

³ '[I]nequality between countries continued to grow in the 1990s, albeit at a slower pace than in the 1980s. Also, there were widespread increases in inequality within countries in the 1980s and 1990s. And there is some evidence to suggest that inequality between the world's individuals was on the rise in the 1980s, but stabilized in the 1990s' (Weller and Hersh 2004, p.473). Moreover,

alternatives. This research effort will support government attempts to achieve high economic growth rates and greater equality, in order to fulfil their MDGs in the shortest possible time. The third and final part outlines the basic features of pro-poor monetary and anti-inflation policies. The literature in this field is relatively scarce, and only a few pointers for further research can be offered here. When developed in detail, pro-poor monetary and anti-inflation policies will become an integral part of a pro-poor policy compact, contributing to the delivery of a stable macro-monetary framework in support of pro-poor goals.

5.1 – Principles of Pro-Poor Economic Strategy

For the Washington consensus,

the cause of poverty reduction is best served by more rapid adjustment to fiscal imbalances, rapid adjustment to lower inflation and external deficits and the use of higher interest rates to achieve these ends, internal and external financial sector liberalization, deregulation of capital controls, deep and rapid privatization of state owned enterprises and, perhaps the strongest unifying factor – rapid and major opening up of an economy to trade and foreign direct investment.⁴

This approach focuses inordinately on short-term stabilisation, and it undercuts the basis for long-term growth.⁵

‘[a] UNDP-supported study by the World Institute for Development Economics Research documents that inequality has risen in two-thirds of the countries for which reliable data are available. A more recent World Bank study also shows that world inequality, across as well as within countries, has been on the rise’ (Weeks 2003). See also Milanovic (2002, 2003).

⁴ Ravi Kanbur, cited in Rao (2002, p.2).

⁵ See McKinley (2001).

The inability of Washington consensus programmes to bring about economic stability and fast stable growth has become increasingly evident during the last twenty-five years. The slow improvement in the welfare of the poor given the available resources in the world economy and the resources that could be generated through faster growth is a severe indictment of mainstream economics and the so-called 'international community'.

The IMF and the World Bank have become increasingly aware of the limitations of mainstream economic adjustment programmes.⁶ The Heavily Indebted Poor Country initiatives (HIPC-1 and HIPC-2) attempt to link standard stabilisation and structural adjustment strategies with pro-poor outcomes, with a view to achieving MDGs. Their most important innovation, in terms of policy formulation and implementation, is the introduction of the PRSPs. In spite of their limitations, the PRSPs can offer a framework for the assessment of poverty in different countries, and a baseline for comparison across different economic strategies in order to select those that may be able to achieve MDGs more rapidly.

Unfortunately, these 'new generation' mainstream economic programmes remain attached to the same failed strategies attempted in the past, plus targeted programmes to relieve poverty. These targeted (focused or marginal) interventions are insufficient to address the severe problems of poverty and relative economic stagnation in most poor countries. For example, economically worthwhile projects often fail to thrive in spite of the availability of new credit lines (or the introduction of micro-credit initiatives) because their economic returns are limited by the low wages and inadequate levels of aggregate demand in the economy. By the same token, if the country's macroeconomic strategy fosters stagnation and the reproduction of poverty, the targeted social programmes and 'safety nets'

⁶ For an overview, see Bird (2001), Buirra (2003), IMF and IDA (1999, 2001), Pender (2001), Unctad (2000, ch.5; 2002, ch.5) and World Bank and IMF (2004).

promoted by the IMF and the World Bank cannot reverse the general trend.⁷ However, even with a significant acceleration of growth many countries will still be unable to achieve their MDGs.⁸ Only a *shift in their growth strategy* can deliver the goals mandated by the United Nations. This section outlines the principles of an alternative (pro-poor) development strategy for poor and middle-income countries.

5.1.1 – Poverty and Growth

Economic growth influences two types of poverty very differently. *Basic poverty* is due to the country's very low levels of income and productivity in a country.⁹ This type of poverty tends to decline with growth ('a rising tide lifts all boats'). Growth creates new income generating activities, produces labour scarcities that can raise wages, increases the demand for foodstuffs and raw materials produced by the poor, and creates other opportunities for the material advancement of large numbers of people (see section 5.2.1). However, economic growth can also create *market-generated poverty*, due to the loss or lack of access to productive assets. Conventional economic growth strategies can create poverty because they lead to the dispossession of large numbers of small peasants and rural labourers and their eviction from the land, and because the structural economic changes that accompany growth deskill the employed workers and eliminate large numbers of jobs. It is not always possible for many workers to find alternative jobs with equivalent pay, or to retrain in order to seek better employment opportunities. The self-employed may also find that their economic prospects are depressed because of their insufficient access to credit and markets.

⁷ See Pasha (2002).

⁸ For an assessment, see <<http://www.un.org/millenniumgoals/>>, <<http://www.undp.org/mdg/>>, <http://www.developmentgoals.com/UNDG%20document_final.pdf> and <<http://www.who.int/mdg/en/>>.

⁹ See Weeks et al (2002, pp.12-14).

The impact of growth on poverty depends on the trajectory of basic and market-generated poverty and the interaction between them. In some cases, income and productivity growth can be so rapid that most people benefit in spite of the possibly rising inequality in the country (e.g., Brazil between the fifties and the seventies, and China since the eighties). Alternatively, GDP growth may be insufficient to trigger a significant reduction in poverty, leading to the stagnation or even decline of the standards of welfare of large numbers of people (e.g., Pakistan, Russia and many CIS countries since the nineties, and most Middle-Eastern, North African and poor Latin American and sub-Saharan African countries since the eighties; see Box 2). These interactions are non-linear. At the early stages of growth basic poverty tends to dominate, and faster growth rates are sufficient to relieve poverty. As the country develops and additional resources become available the importance of distribution increases further (i.e., the elasticity of poverty with respect to growth tends to decline).¹⁰ However, at all stages of development pro-poor (distributive) economic policies can increase the poverty-reducing impact of growth, as is shown below.

5.1.2 – Pro-Poor Growth and Distribution

This section briefly outlines the principles of pro-poor economic strategies (or pro-poor growth regimes¹¹) and their implications for policy formulation and implementation. These strategies have three distinguishing features.

First, they prioritise *rapid growth*, *structural transformation* and *distribution*, subject to the preservation of macroeconomic stability.¹² These objectives are very different from those of mainstream policies, which seek to ‘roll back the state’ and achieve static market-based allocative efficiency and price stability.

¹⁰ See Dagdeviren et al (2002) and Weeks et al (2002).

¹¹ See Rao (2002).

¹² See Pasha (2002, p.3).

Second, pro-poor growth is equity-based growth,¹³ or *growth through redistribution*. Pro-poor growth not only needs to be faster, it must also *benefit the poor more than the rich* in order to reduce absolute as well as relative poverty.¹⁴ It is essential to shift the pattern of growth in a more equitable direction in order to achieve MDGs as rapidly as possible and, in any case, by 2015.

Third, redistribution and growth should be pursued directly, in other words, they should be independent from trickle-down; moreover, the ensuing social welfare improvements should not be merely marginal: they must be unambiguous across a broad spectrum of measure of welfare.

Experience shows that the countries that have achieved the most significant successes in poverty reduction have combined economic growth with structural economic transformations and greater equity both *before* and *through* the process of growth.¹⁵ This is not necessarily because equality is, in general, beneficial for growth.¹⁶ The relationship between these variables, if any, plays no role in the choice of pro-poor rather than mainstream growth strategies. For, in the pro-poor regime, equality is not an instrument to achieve growth maximisation, and the success of pro-poor strategies should not be judged primarily by the achievement of high GDP growth rates. Quite the contrary: in pro-poor strategies economic growth *serves* equality, and growth is *conditioned* by (and it should be conditional upon) the reduction of absolute and relative poverty and the improvement of the living standard of the majority of the population.

Distribution plays an important role in pro-poor strategies at two levels. First, pro-poor goals can be achieved more easily if the distribution of assets is modified by

¹³ See McKinley (2003).

¹⁴ See, for example, McKinley (2003) and Weeks (2003, p.3).

¹⁵ See Pasha (2002).

¹⁶ This relationship has been disputed; for a survey, see Cramer (2000).

public policy, for example, through land reform,¹⁷ universalising basic education, skills and training programmes, the introduction of pensions and other welfare entitlements, and so on.¹⁸ In fact, ‘empirical evidence ... consistently indicates that size distributions of income are quite stable, in the absence of radical changes in institutions and political power’.¹⁹ Second, the dynamic processes of income generation and distribution also need to be transformed in order to benefit the poor disproportionately. This includes support for the development of strategic economic activities, directed credit lines, employment generation programmes, the creation of labour scarcities, incentives for wage increases for low-skilled workers, and so on (see section 5.2).²⁰

5.1.3 – Pro-Poor Growth Policy Framework

Pro-poor policies pursue *real* (rather than nominal or monetary) goals, and the achievement of these goals requires the harnessing of all the available policy tools. This implies that nominal targets or anchors can play at best a secondary role in pro-poor strategies (see section 5.3). In order to achieve these objectives pro-poor policies need to be *consistent, democratic and co-ordinated*.

Macroeconomic policy consistency includes both sustainability and efficiency. Sustainable policies should not create severe macroeconomic turbulence or generate major welfare traps and disincentives. Unsustainable policies cannot be maintained in the long-term, and they should normally be avoided even for short periods.

¹⁷ ‘In most countries, redistribution of land to the poor will produce both efficiency gains and immediate benefits for the poor. Apart from bestowing the rent of land on cultivators, a more equal land distribution will raise labor incomes by raising both land yield and the demand for labor’ (Rao 2002).

¹⁸ ‘[M]acroeconomic policies can influence whether growth is pro-poor, but ... such policies cannot be a substitute for an equitable distribution of productive assets’ (McKinley 2001).

¹⁹ Rao (2002).

²⁰ ‘[R]edistributive policies ensure lower poverty today, and faster reduction of poverty in the future’ (Osmani 2001, p.38). See also McKinley (2003) and Pasha (2002).

Pro-poor policies also need to be efficient, or achieve their stated objectives at the lowest possible cost (including the costs of implementation and monitoring).

Policy efficiency is not given *ex ante* or in the abstract; it varies with the country and its circumstances, and it needs to be assessed continually. NMPC policies, for example, can be very costly (see sections 3 and 4). They tend to be excessively contractionary, induce unemployment, deindustrialisation, the build-up of excess foreign and domestic public debt and asset bubbles, and foster foreign currency waste in luxury imports and asset bubbles, among other ills. Excessively loose monetary policies can also be costly, because they can trigger consumption bubbles, malinvestment, inflation, capital flight and balance of payments crises. The potential costs of misguided macroeconomic policies and their distributive implications should be considered in order to calibrate the use of different instruments and facilitate the achievement of MDGs.

There can be no guarantee that pro-poor monetary policies (explained in section 5.3) will be less costly than the alternatives. In order to minimise their cost and check their internal consistency it is important to foster an environment in which the objectives of public policy are constantly scrutinised, the efficiency of the chosen instruments is continually assessed, and the policy outcomes are regularly checked against the initial goals.

In other words, *pro-poor policies must be democratically accountable*. Although policy accountability can help to ensure the consistency and efficiency of macroeconomic policy, its importance is not primarily instrumental. Macroeconomic policy plays a key role in the determination of the levels of welfare, the work patterns and the material prospects of the majority of the population.

The *only* legitimate way to select the targets for government action and the appropriate policy tools is by involving the legislature and civil society in the choice, implementation and assessment of macroeconomic policy. This is especially important because the desired pro-poor outcomes are both complex and diverse; moreover, multiple restrictions affect macroeconomic policy, the potential policy tools are diverse, and there is a non-linear relationship between economic circumstances, policies and outcomes. Democratic participation and accountability will enhance the legitimacy of the government's policy objectives, buttress the regulatory framework required by the chosen policies, and help to assess the implications of deviations from the selected targets. In addition to this, mass participation in policy debates will afford people the chance to influence the design of policies that will redistribute income and opportunities in the country.²¹ These debates about macroeconomic policy should be welcomed, because it will help to break the monopoly of the moneyed interests, professional politicians, paid advisors, lobbyists and established academics in the selection, implementation and evaluation of economic policy. Paraphrasing Milton Friedman, *economic policy is too important to be left to the policy-makers*.

Finally, *pro-poor policies need to be co-ordinated*, at two levels. First, pro-poor objectives are complex, and they can be achieved only through the use of a large number of policy instruments. These instruments do not operate in isolation from one another. In the case of monetary policy, for example,

[c]oordination is necessary because ... all policy tools interact with each other, and what occurs when a government uses any given tool depends on the state of the other tools and on conditions prevailing at the time. So coordination of several policy tools is vital. The more coordination there is

²¹ See Weller and Hersh (2004, p.482).

among monetary tools, and between them and other policy tools, the more workable monetary policy is expected to be.²²

Therefore, pro-poor monetary policies should be closely co-ordinated with fiscal, financial, trade, exchange rate and other policies (see section 5.3.3).

Second, pro-poor policies also require co-ordination between private and public sector activities and the regulation of intersectoral and intertemporal resource allocation (including international capital flows) by the state through activist industrial and financial policies. This is not because the state is either necessarily efficient or inherently 'good'. Policy activism and state-led co-ordination of public-private activity are *necessary* because the state is a fundamental tool of collective action. The state is the *only* democratically accountable institution that can influence the pattern of employment, the production and distribution of goods and services and the distribution of income and assets. Only the state can limit the power of private interests, raise sufficient funds for democratic economic reforms, and ensure that the demands of the majority guide private economic activity:

In forming an alternative development strategy, the state might most usefully conceive of its role toward the private sector as one of constructing or shaping markets in ways that direct the private sector toward social ends. There are of course limits on the extent to which the state can direct private businesses; they exist, after all, to make profits. Nonetheless, within broad limits the state can move business toward social ends.²³

The expansion of economic and political democracy requires the extension of the political sphere and the (re)construction of state policy-making and managerial

²² Sicsú (2001, p.674).

²³ MacEwan (2003).

capacity in many poor countries. This will require, among other things, dismantling at least partially the administrative and policy structures that currently rival the state institutions in those countries, and reducing the interference of NGOs and international organisations on the selection, management and appraisal of investment programmes, even when they are aid-funded (see section 5.2).²⁴ This does not imply that the state should aim to ‘take over’ the economy. Pro-poor economic strategies are distinctive not because the state manages individual firms, but because of the way in which the state co-ordinates economic activity for democratic and distributive ends. State ownership of specific assets is a secondary and relatively unimportant issue. What matters are the objectives of government policy, and how state institutions interact with one another and with private concerns.

Policy consistency, accountability and co-ordination imply that policy rules have only a very limited role to play in pro-poor strategies. *Policy discretion* is usually more appropriate, because only discretion is compatible with the continuous search for the most efficient combination of instruments and targets to deliver pro-poor outcomes, the accountability of the state, and the preservation of macroeconomic stability. Policy rules, however worthwhile in themselves, cannot be allowed to overrule the democratic process. Government objectives, whether real or nominal, should always be open to scrutiny, and these debates must play an important part in the formulation, implementation and assessment of economic policy.

5.1.4 – Policy Objectives and Constraints

The accomplishment of pro-poor goals such as MDGs is subject to several constraints. They include, for example, the minimisation of economic volatility, inflation and the domestic public debt, balance of payments equilibrium and the

²⁴ See Unctad (2000).

stabilisation of the real exchange rate. These objectives and constraints can be usefully summarised by *achieving MDGs subject to macroeconomic stability*.

The reader may wonder why economic growth does not figure either as the principal objective or as the most important constraint to pro-poor growth. The reason, as was indicated in section 5.1.2, is that growth is *not* an end in itself. Growth is a source of resources for greater human welfare – it is a means to an end. What *really* matters is whether growth is translated into human development and poverty reduction in particular.²⁵ Similarly, economic stability is a constraint to be managed, rather than an objective in itself.

It is important to distinguish clearly between pro-poor *goals* (such as MDGs) and *constraints* (macroeconomic stability). Pro-poor policy goals include an array of desirable outcomes that should be described in detail and achieved within a given time-frame. In contrast, the macroeconomic constraints should *not* be defined clearly: the optimal policy is *constructive ambiguity* (or deliberate lack of clarity).²⁶ Listing a set of restrictions to government action (such as maximum fiscal deficits, inflation rates or exchange rate levels), many of them determined arbitrarily, side-by-side with the pro-poor targets devalues the latter, introduces artificial limitations to the government's programmes and confuses policy implementation because it signals that the government is only conditionally committed to its pro-poor objectives. For example, what should the government do if it had announced that the maximum acceptable inflation rate is 10 per cent, and inflation reached 12 per cent? Which of the pre-announced government commitments will be abandoned – the maximum inflation rate or the pro-poor income, housing and health programmes?

²⁵ See McKinley (2001).

²⁶ Following, in a different context, the suggestion of Carare and Stone (2003, p.20); see section 1.4.2.

Macroeconomic instability should be avoided because it could impair the achievement of the pro-poor targets either directly (if inflation redistributes income towards the rich, or if exchange rate instability limits essential imports), or indirectly (if it triggers capital flight, erodes popular support for the government, or offers easy targets for the opposition). However, stability – just like growth – is a means to an end, and it matters only insofar as it facilitates the achievement of socially desirable objectives. The government will decide how best to address any macroeconomic imbalances in order to ensure the success of its pro-poor programmes.

5.1.5 – Possible Objections

Pro-poor rhetoric is rapidly becoming fashionable. It frequently appears even in IMF documents, and there is the risk that this concept will be diluted beyond recognition. No one seems to be against some form of ‘pro-poor’ growth – but, in some cases, this is simply a fig-leaf for the same old growth strategy that has already failed to deliver in most countries.

Arguments against pro-poor strategies could be divided into three groups. First, at a static level, some countries are ‘too poor to redistribute’ – their per capita income is so low that redistribution would have little impact on the level of poverty. This argument has been shown to be invalid: redistribution can help both statically and over time.²⁷ Second, at a dynamic level, there may be a trade-off between growth and distribution: although distribution can reduce poverty to some extent, economic growth does so in a more sustainable manner. This argument is fallacious, because economic growth *always* redistributes income and wealth (see section 5.1.1). Therefore, the distinction between static and dynamic redistribution is purely analytical; in reality, they are inseparable. Since redistribution is inherent in the growth of a market economy, it is appropriate that

²⁷ See Dagdeviren et al (2002).

it be subjected to policy influence, through a democratically chosen development strategy.²⁸

Finally, it could be argued that pro-poor strategies are difficult to implement, and several governments have failed dismally in their attempts to follow similar strategies in the past. This is a serious argument, and there is no guarantee that the future will not bring similar failures. However, pro-poor goals are inherently worthwhile, and government policy is at least formally accountable to the majority through democratic political channels. This is more than can be claimed for the international financial institutions, which claim to offer ‘guidance’ to developing countries, and the (financial) markets that wish to lead the growth process (see sections 3.5 and 3.6).

5.2 – Pro-Poor Macroeconomic Policies

The previous section has outlined the basic objectives and limitations of pro-poor and democratic economic strategies. This section develops, in more detail, five elements of these strategies. They include the importance of growth and investment, fiscal policy and public investment issues, employment and productivity, the external sector and the role of social programmes in pro-poor development programmes.

5.2.1 – Growth and Investment

It was shown in section 5.1.1 that economic growth is critically important for the success of pro-poor development strategies. Sustained economic growth is one of the key driving factors behind the reduction of world poverty; moreover, if it is equitable and appropriately targeted, growth can also contribute decisively for the improvement of the relative position of the poor (see section 5.1.2).

²⁸ See Dagdeviren et al (2002).

Economic growth contributes to poverty reduction in many different ways. Growth increases the availability of goods and services and expands the country's consumption possibilities. It creates employment, expands markets and sales income, and raises wages through the creation of labour scarcities (see section 5.1.1). Growth also helps to fund distributive social programmes and finances the provision of public goods. Finally, economic growth can also help to generate the savings and the financial development required to fund investment and consumer spending. In the absence of growth (and, secondarily, foreign transfers, such as international aid and debt forgiveness, see section 5.3.4) poverty-reducing outcomes depend to a much greater extent on distribution, which can generate severe political tensions.

These principles imply that pro-poor strategies are 'bolder and more expansionary'²⁹ than what is permissible under the mainstream policy compact that inspires the NMPC. However, high growth rates are insufficient. The relationship between economic growth and poverty reduction is determined by the distribution of income and, especially, its distribution near the poverty line, which depends on the circumstances of each country. In order to maximise its distributive and poverty-alleviating impact growth should, in general, be concentrated in two areas of the economy. First, the sectors that directly benefit the poor: those where the poor work, that generate income and employment for the poor, and that produce goods and services consumed primarily by the poor (for example, small-scale agriculture, construction and the informal sector).³⁰

Second, growth should be geared toward the promotion of investment. Although investment is the driving force of growth,³¹ growth is also the driving force of

²⁹ McKinley (2004, p.1).

³⁰ See Pasha (2002).

³¹ There is no question that higher rates of capital formation are associated with higher growth rates; see, for example, Weller and Hersh (2004, p.492).

investment because rapid and sustained growth generates the demand that makes individual investment projects viable.³² Moreover, low investment rates delay and complicate the task of reallocating economic resources towards pro-poor objectives. The manipulation of interest rates is likely to prove insufficient to the task of inducing the required levels of investment, since there is no evidence that marginal shifts in interest rates can trigger the desired response.³³ In order to kick-start the virtuous circle of growth and rising investment the state needs to identify the sectors that hold the key to rapid growth, the reduction of inequality and the alleviation of the balance of payments constraint (see section 5.2.4). Their expansion should be fostered through targeted (vertical) industrial policies, public investment and *focused* incentives for the expansion of capacity and output:

The concept of ‘focused’ incentives excludes the traditional sort of broad investment incentives often employed by governments – tax holidays for investments of any type or general protections from foreign competition. In shaping an alternative economic development strategy, a government does not simply want more investment; it wants more investment of a certain kind. This requires that incentives be focused.³⁴

In the middle-income countries these government policy priorities should be funded primarily by domestic sources. Foreign savings tend to be unreliable, difficult to target, and they are often inimical to pro-poor objectives.³⁵ Raising the necessary resources domestically will require a concerted effort, since the available savings rates are usually insufficient to support ambitious pro-poor objectives. In most countries it will be necessary to increase tax rates through a more progressive tax system, the taxation of unearned incomes, and the additional

³² See McKinley (2001) and Rao (2002).

³³ See Rao (2002).

³⁴ MacEwan (2003).

³⁵ The suggestion that countries should rely primarily on domestic rather than foreign savings is supported by the pioneering work of Feldstein and Horioka (1980) and by more recent research by Calvo, Leiderman and Heinhart (1993). For a political economy interpretation, see Palma (1998).

tax revenues generated by economic growth. It will also be necessary for the state to set up or expand long-term savings programmes jointly with the private financial system in order to fund pensions, the expansion of housing and infrastructure, education and training programmes and other costly pro-poor projects. In contrast, in very poor countries the savings potentially available could be insufficient to permit the achievement of MDGs (or other pro-poor objectives) even under the best possible combination of policies. In this case, the rapid success of pro-poor strategies may require the expansion of foreign aid flows, other unrequited transfers (such as workers' remittances) and debt forgiveness.³⁶

5.2.2 – Fiscal Policy and Public Investment

Fiscal policy is a powerful tool for macroeconomic policy, and it is critically important for pro-poor programmes.³⁷ The standard (NMPC and Washington consensus) macroeconomic framework argues that the size of the public sector should be kept to a minimum because low taxes, limited regulation and limited public investment will create incentives for private sector activity, which should lead the process of growth and bring about the alleviation of poverty. In contrast, pro-poor strategies require that the public sector should induce, regulate and sustain the process of growth, direct significant resources to priority sectors and preserve macroeconomic stability, since middle-income and poor countries are prone to experience more severe economic crises with greater frequency than the rich economies.³⁸

³⁶ '[T]he bulk of the extra investment in basic services and anti-poverty programmes will have to come from domestic resources, not from external sources. However, this does not diminish the marginal value of ODA. Indeed, foreign aid can play a critical role in overcoming obstacles in the transitory phase towards pro-poor policies since the latter are bound to meet stiff resistance from several quarters' (Vandemoortele 2004, p.16).

³⁷ For a reassessment of the importance of fiscal policy, see Arestis and Saywer (2003). Pro-poor fiscal policy is reviewed in detail by Kakwani and Son (2001) and Weeks (2003).

³⁸ Weller and Hersh (2004, p.488) claim that the volatility of growth hurts the poor even more than low growth rates.

Let us start from public investment and public expenditures more generally. They can boost aggregate demand (potentially sparking the recovery of a stagnant economy), loosen the supply constraints on long-term growth and help the reallocation of resources towards poverty reduction objectives, especially in economies operating below potential.

Although mainstream economics insists that public investment crowds out (and is less efficient than) private investment, the literature offers no firm evidence supporting this claim. Quite the contrary: a significant body of work indicates that public investment can crowd in private investment either in complementary areas of the economy or in upstream or downstream activities (e.g., supplies of inputs and consumables, maintenance, trading and financial services, labour training and supply and so on). Public investment can also support private investment directly if it builds physical infrastructure (rural roads and ports, irrigation systems, electricity generating capacity and transmission lines, and so on), boosts labour productivity (through public education and training programmes, health provision, etc.), or fosters private savings:

Contrary to the view that higher fiscal deficits ‘crowd-out’ private investment by raising interest rates, there is persuasive empirical evidence that if higher fiscal deficits are caused by larger public investment outlays then this may actually ‘crowd-in’ private investment on a net basis by removing physical bottlenecks of infrastructure and thereby raising the factor productivity of private investment. In addition, larger public outlays on education and health raise the productivity of the poor and equip them better to get out of the poverty trap.³⁹

³⁹ Pasha (2002). Alternatively, ‘[p]ublic investment plays a leading role in stimulating growth by inducing greater private investment, both domestic and foreign, and by counteracting the contractionary effects of such policies as import-depressing devaluation. If properly designed, public investment, such as labour intensive public works, can in fact help lower the need for capital imports. Growth also serves to raise the share of savings in gross domestic product, which can then be used to finance the additional investment’ (McKinley 2001).

Public investment can also support foreign investment in the country:

[T]wo [Asian] countries with the strongest public investment programmes, China and Vietnam, also had the highest rates of growth. Both countries attracted large inflows of foreign direct investment, suggesting that, at least, major public investments did not discourage such inflows and may have facilitated them.⁴⁰

Evidence shows, first, that public investment has played a key role in fostering growth and reducing poverty in several dynamic economies, especially in East Asia,⁴¹ and, second, that when public investment falters private sector profitability often declines, *reducing* the resources available for investment.⁴² In this sense, adequate levels of public investment can be essential for sustained pro-poor growth.

In order to support economic stabilisation and large public investment programmes poor country governments need to jettison the excessively restrictive fiscal policy stance imposed by the NMPC and the Washington consensus and adopt more proactive policies.⁴³ This is not necessarily inflationary – in fact, *there is no evident relationship between fiscal deficits and inflation*.⁴⁴ Nevertheless, it is better to err on the side of stability rather than to generate unsustainable disequilibria, especially given the size of the social and investment programmes required by a pro-poor growth strategy. Experience indicates that if public deficits are used to finance investment that expands aggregate supply, and as long as they

⁴⁰ Weeks (2003).

⁴¹ See Vandemoortele (2004) and Weeks (2003).

⁴² McKinley (2004, p.9); see also Rao (2002).

⁴³ '[T]he obsession with eliminating fiscal deficits (and, thereby, current account deficits), if achieved through cutbacks in public expenditure, especially on development and social services, has retarded the process of growth and created more poverty' (Pasha 2002).

⁴⁴ See Fischer, Sahay and Végh (2002, pp.876-7).

are financed in a sustainable fashion (i.e., if the additional public debt can be paid off by the tax revenues generated by future growth) their impact should not be unduly inflationary either in the short or the long-term.⁴⁵ Alternatively, if the government monetises the deficit, perhaps because the financial markets in very poor countries are insufficiently developed, care must be taken not to fuel aggregate demand excessively because of its inflationary implications.

Proactive and pro-poor fiscal policy can be sustainable only if the tax system of poor countries is modernised and expanded.⁴⁶ Tax revenues play a fundamental role in the mobilisation of resources for the allocative, distributive, growth and stabilisation functions of the state in poor countries, especially in the light of their weak financial systems (see below).⁴⁷ However, this potential source of funds has been both underestimated and underutilised:

The evidence clearly shows that the tax system in many countries has become less equitable and less pro-poor. Reforms are urgently needed in direct and indirect tax policies to generate more domestic resources for the MDGs and do so in a more progressive way.⁴⁸

There is a lot of scope for increasing tax revenues in developing countries and, simultaneously, to distribute income. These tax reforms will require the stricter enforcement of the existing tax laws, higher tax rates, closing the existing loopholes and eliminating many of the exemptions and deductions favouring the rich, taxing wealth and large or second properties in rural and urban areas, and

⁴⁵ See Rao (2002).

⁴⁶ '[T]he viability of an alternative program of social reform depends on more tax revenue' (MacEwan 2003).

⁴⁷ 'Whether or not higher taxes retard economic growth depends a great deal on what is done with those taxes – i.e., on how the government spends the money. If, for example, the government spends the money on creating a more effective infrastructure and a more productive workforce, the higher taxes are likely to lead to more, not less economic growth' (MacEwan 2003).

⁴⁸ Vandemoortele (2004, p.10).

taxing interest income, capital gains and international capital flows.⁴⁹ The most important constraint to the expansion of the tax base is not economic or managerial (although these are surely relevant) – it is political. However, domestic pressures for economic privileges or threats of capital flight should not prevent the state from mobilising domestic resources:

While systematic international evidence of the relationship between tax rates and capital movements is generally lacking, experience within the United States is instructive. There are no restrictions on capital movements among the fifty states, but state governments have a good deal of taxing and spending authority. Thus the United States economy provides a useful basis on which to draw general inferences about the response of business location decisions to government taxation and spending policy. The evidence from U.S. experience suggests that governments' macroeconomic policies certainly make a difference for business location decisions, but overall there remains a good deal of leeway for government action.⁵⁰

In sum, pro-poor programmes require more expansionary fiscal policies funded by a larger tax base. However, it is important to avoid exaggeration – but not because of groundless fears about inflation. Critics of the mainstream often argue that pro-poor strategies require loose fiscal, monetary *and* exchange rate policies (see sections 5.2.4 and 5.3). This suggestion is potentially risky for three reasons. First, support for these 'fully expansionary policies' draws upon a narrow reading of the experience of the United States and large Western European economies between the early twentieth century and the mid-seventies. These countries could either print the world currency (especially Britain before World War 1 and the US after World War 2), or they had much easier access to foreign currency than today's

⁴⁹ See McKinley (2003).

⁵⁰ MacEwan (2003).

poor countries. This experience is hardly relevant to most poor countries, whose balance of payments constraint is much tighter.

Second, in poor countries loose fiscal, monetary *and* exchange rate policies could generate unsustainable booms that would be destabilising both economically and politically. This is especially true for economies that are initially locked in stabilisation traps – that is, starved of investment for long periods, and where high unemployment coexists with low spare capacity in key sectors of the economy (see section 4.5). In these cases, a sudden and radical policy reversal could trigger accelerating inflation and send the currency spiralling downwards.

Third, the ‘fully’ expansionary option is not always politically feasible. The rapid shift of the fiscal stance and the build-up of the domestic public debt could easily become a lightning rod for the critics of the government’s strategy. A rapid deterioration of the fiscal balance is likely to bring the wrath of the IMF, World Bank and the US Treasury Department and heavy criticism by the local media and the financial sector. This could destabilise the government, trigger capital flight, speculation with foreign currency or treasury bills, inflation and a balance of payments crisis *before* the expansionary and distributive impact of the government’s pro-poor policies could be felt.

Recent experiences in Latin America and elsewhere show that excessive fiscal, monetary *and* exchange rate policy laxity can block economic growth, generate political instability and prevent the accomplishment of pro-poor objectives.⁵¹ In order to achieve the desirable outcomes, fiscal policy should be calibrated in order to deliver what monetary and exchange rate policies cannot offer, especially in poor countries: targeted investment programmes, incentives for the private sector to support the government’s pro-poor goals, and economic stabilisation when this becomes necessary.

⁵¹ See, for example, Glewwe and Hall (1994), Lago (1991) and Paus (1991) for the Peruvian case.

5.2.3 – Employment and Productivity

Fiscal policy can offer an important contribution for the expansion of employment opportunities, technological innovation and productivity growth in developing countries.

It is essential to upgrade the technological and productive capabilities of poor countries because productivity gains are the key to sustained growth and rising incomes in the long-run.⁵² These gains can be achieved in at least two different ways.⁵³ One is the development of mass production facilities where low-paid unskilled workers engage in repetitive tasks at high speed in traditional plantations or in manufacturing industries producing clothing, shoes or established electronic products, as in Mexico's *maquiladoras* or in most Asian export processing zones. Alternatively, highly paid skilled workers could be expected to make decisions about their tasks, work co-operatively and apply sophisticated technical skills in the services industry, specialised agricultural production or the manufacture of sophisticated electronic goods, fine chemicals and machinery made to order. Obviously most middle-income and poor countries cannot move directly into these highly advanced production processes because they lack the technology, infrastructure, skills, managerial capacity and finance to do so. However, this type of development is precisely that which pro-poor and democratic economic programmes should aim for, even if they are achievable only in the medium and the long-run, and only in certain areas of the economy.

The 'high road' to productivity growth offers several advantages.⁵⁴ It opens valuable export opportunities, that help to relieve the balance of payments constraint (see section 5.2.4). It requires the development of chains of related

⁵² McKinley (2003).

⁵³ See MacEwan (2003).

⁵⁴ See Korzeniewicz and Smith (2000) and Ocampo (1998, 2002).

activities that, if internalised, can generate employment and growth in other areas of the economy. It demands (and supplies) a skilled workforce that can be trained by public education programmes and that could transfer their know-how to other areas of the economy, or open small businesses. These workers will be better paid than the average, which will help to raise the demands of the workers employed elsewhere. Finally, these firms can set high standards of workplace safety and security that will facilitate the regulation and, eventually, the elimination of degrading and unsafe working conditions in other areas of the economy (e.g., in sweatshops).

These outcomes are neither necessary nor automatic. Higher productivity and profitability give firms the scope to improve pay and conditions, but the market does not always spontaneously generate exports, internalise value chains, pay salaries commensurate with productivity or deliver minimum health standards in the workplace. State regulation and incentives are essential to achieve these outcomes.

Regulation should make it difficult for firms to increase profitability by cutting wages, arbitrarily extending the working day or bypassing the existing health and safety rules. Productivity growth and better working conditions can be supported by legislation supporting trade union activity, rising minimum wages, and the offer of tax and other incentives for investment in priority sectors, the introduction of new technologies and the payment of high wages. These policies can be partly funded by progressive income taxes and social security contributions (see section 5.2.2).

Relatively high wages will ensure that the most productive firms will reap extraordinary profits while their inefficient competitors face losses. Export incentives and targeted import protection (to the maximum extent permitted under

WTO rules) will offer an alternative avenue for profitability and growth.⁵⁵ At the same time, the workers left unemployed because of the bankruptcy of the inefficient firms or the declining availability of low-paid jobs should be retrained with public funds in order to find more productive and better-paying employment.⁵⁶ These medium-term policies can help to raise economic productivity, increase the flexibility of the labour markets and reduce structural unemployment, while creating incentives for exports and for long-term productivity growth in industry, large-scale agriculture and the services sector.⁵⁷

In parallel, and at a more immediate level, it is essential to offer incentives for the development of labour-intensive industries producing non-tradable goods because

⁵⁵ ‘Cambodia, Mongolia and Nepal have banked heavily on garment and textile exports but international competition is intense in these subsectors and foreign direct investment is footloose. The [case of] Sri Lanka ... warns that too many developing countries are specializing in the same low-value-added products such as garments and have not diversified their manufactured exports. Instead, they should be concentrating on relatively income elastic and price inelastic export products’ (McKinley 2003).

⁵⁶ ‘One example of focused incentives ... is a “training-for-jobs” program. In such a program, the government provides training programs that prepare workers with the specific technical skills needed by a firm. The firm, in return, makes an investment and hires the already-trained workers. A training-for-jobs program lowers costs for an investor and thus provides an incentive in the same manner as does a tax holiday ... [but] a training-for-jobs program has a special advantage over other forms of investment incentives. Even if the firm moves away, society has raised the skill level of its workers who remain. While specific skills are not always transferable to other activities, in acquiring those specific skills workers have necessarily gained a valuable general skill, a greater capacity to learn. Training-for-jobs programs ... [are funded through a] “levy-grant system” ... in many countries. The government creates a small new tax (one or two percent of earnings) on firms – the levy; but firms receive a rebate – the grant – if they implement training programs that raise the technological level of their work forces’ (MacEwan 2003).

⁵⁷ ‘[A] coordinated policy of support for education and training coupled with protection of production activities based on relatively high levels of skill can be advantageous in terms of maximizing income over the longer run ... [T]he reasons are well known ... protection allows the development of activities that will be consistent with the longer run availabilities of skilled labor (given the programs of education and training); the development of these activities themselves creates new skills, as people learn by doing; and these sorts of activities generate extensive externalities that tend to spread new skills through the general workforce. A policy of protection may be viewed as an investment: a cost (higher prices for goods) incurred in the short-run in order to gain in the long-run (higher and more rapid growth of productivity). Through programs of skill upgrading and protection, a government can promote decisions that are consistent with the *markets that will exist* ... [O]ne lesson [from South Korea and other countries in East Asia] is that an emphasis on education and training coupled with regulation of a country’s foreign commerce can yield substantial gains. In fact, it would appear that all countries that have achieved development – from Japan to Western Europe to the United States – have done so with extensive government regulation of foreign commerce’ (MacEwan 2003).

of their employment-generating potential. These industries (especially small-scale agriculture, construction, small-scale workshops and some services industries, as well as public works) can support the absorption of the labour force and offer opportunities for on-the-job training for entrants on the formal labour markets.⁵⁸ At the same time, they could help to relieve localised supply constraints, for example, through the supply of food, inputs for the manufacturing industry, exportables or the construction of rural roads or irrigation facilities in public works programmes. These incentives and works programmes can be funded by general taxation (at any level of government) and by targeted credit by state-owned and private financial institutions. Although the state should aim to provide opportunities for employment for all, it should *not* commit itself to the elimination of unemployment, for example through an ‘employment of last resort’ programme, at least initially, because of its fiscal and inflationary implications.⁵⁹

In most poor countries it is especially important to support the development of agriculture and its linkages with other economic sectors for three reasons: its current economic importance, the fact that most poor people live in rural areas, and the potentially severe dislocations to labour and agricultural production due to WTO-sponsored trade liberalisation. The Chinese, Indonesian and Vietnamese strategies between the seventies and the nineties can provide valuable examples for other developing countries as they attempt to raise agricultural productivity, boost the links with agriculture and other dynamic economic activities and increase the scope for the production of exportable goods.⁶⁰ In order to do this, it

⁵⁸ ‘As the level of income is the key determinant of poverty and as productive employment is the principal source of income, expanding gainful employment opportunities has to be a major element in the strategy of poverty reduction... employment growth depends upon the growth of the economy... The rate of employment growth is also influenced by the sectoral composition of economic growth, the choice of technology and the degree of effective functioning of the labour market. If economic growth is concentrated in sectors in which most of the poor work, then this is likely to have a positive impact on poverty reduction’ (Pasha and Palanivel 2004, p.16). See also McKinley (2003).

⁵⁹ For a critique of these programmes, see López-Gallardo (2000).

⁶⁰ See Karshenas (2001).

may be necessary to transform significantly the existing land tenure systems and invest heavily in better technology and physical and social infrastructure:

Very few countries in the world have experienced rapid and sustained growth without agricultural growth either preceding or accompanying it... strong agricultural growth has been a feature of countries that have successfully reduced poverty at different times... for the same rate of economic growth, the impact on poverty is likely to be more pronounced the faster the rate of agricultural growth.⁶¹

Policies for promoting faster and sustainable agricultural development can focus on the

[d]iversification of agriculture into labour-intensive high-value agricultural commodities such as horticulture and livestock for increased profit incentives and employment opportunities. This may require intervention by the state initially in the process of marketing and in providing minimum support prices to help farmers manage the risks of moving into new economic activities ... Strengthening of the backward and forward linkages between the agricultural sector and the off-farm sector in the rural areas in order to create a virtuous cycle of growth of incomes and employment ... [and the development] of small and medium-scale rural enterprises for agri processing and provision of agricultural inputs will require greater

⁶¹ Pasha and Palanivel (2004, pp.18-19). Moreover, '[its] low productivity levels indicate that agriculture still retains considerable surplus labour, which nonfarm enterprises or urban manufacturing and services will have to absorb in the future. The lack of irrigated land and the slow growth of crop production in many ... [poor Asian] countries ... also suggests that there remains a substantial need for increased public investment in rural areas in order to boost productivity and increase output. This is critical for improving the conditions of the large numbers of rural poor ... [T]he countries that have made the most progress against poverty have concentrated efforts on agricultural and rural development' (McKinley 2003). See also Kay (2002).

outreach for extension of rural credit, both farm and off-farm, by financial institutions, specialised or otherwise.⁶²

Focusing on low-productivity small-scale labour-intensive sectors such as family agriculture is unlikely to deliver the employment and productivity growth that are essential for the long-term success of a pro-poor development strategy. It is essential to plug these sectoral initiatives into broader programmes of education, training, technological development and labour transfer to high-productivity sectors in order to deliver higher productivity and better living standards for the poor.⁶³

The growth of the demand for skilled and unskilled labour, greater economic dynamism and more intense trade union activity will foster workers' demands for better pay. This should be welcomed, because higher wages are essential to improve the welfare of the majority. However, wage growth cannot exceed productivity growth by a large margin and over long periods of time because of its potential implications for profitability, investment and the fiscal balance. This is a difficult dilemma, and short-term solutions will have to be negotiated sectorally. In certain sectors unit costs will decline as sales increase; in others costs may be constant or even increase, and certain sectors (e.g., public works and public services) will be funded entirely by general taxation – no solution will be optimal for all these sectors at the same time. In general, however, it is essential to give the maximum leeway for wage growth and equity through, on the one hand, sustained productivity growth and, on the other hand, centralised negotiations involving the workers, the employers and the government, in order to try to strike

⁶² Pasha and Palanivel (2004, pp.30-31).

⁶³ 'The longer-term objective of all development is to move the workforce, and poor workers in particular, out of low-productivity sectors, poorly resourced regions and low-skilled employment. In most cases, this would imply moving poor workers out of agriculture and into industry and a more modern service sector. If industry is able to grow rapidly enough and generate employment broadly enough, poverty will be reduced as a result of the movement of poor workers into higher-productivity, higher-paid jobs' (McKinley 2003).

a balance between wage growth, productivity growth and economic stability. In these negotiations regulation, targeted credit, export and employment incentives and public sector intervention are some of the instruments available to support the search for pro-poor outcomes.

5.2.4 – The External Sector

The currencies of poor countries do not function as international means of circulation or reserve value, and they do not serve as units of account for international transactions. This limitation severely restricts the ability of these countries to command resources in the world economy – it imposes a balance of payments constraint. The balance of payments constraint is probably the most important restriction to long-term growth in poor countries (see sections 3.3 and 4.2). The rich countries have a more flexible balance of payments constraint, and they can almost always bypass supply bottlenecks through imports. In their case, the supply of labour is often the binding constraint to growth (and excess demand for labour can sometimes trigger inflation). In contrast, in the poor countries labour is relatively abundant, and it is the scarcity of foreign exchange that tends to limit growth.⁶⁴ The binding constraint can trigger balance of payments crises, inflation, unemployment and other destabilising processes.

The balance of payments constraint includes two types of restrictions, on trade (the current account) and capital flows (the capital and financial account). Washington consensus programmes recommend trade liberalisation in order to foster productivity growth, and the relaxation of the restrictions on capital flows in order to attract foreign savings that will finance any current account deficits. This recipe is not conducive to macroeconomic stability or the welfare of the poor, and it should be rejected. A different set of arrangements, compatible with macroeconomic stability and pro-poor outcomes, is outlined below.

⁶⁴ See, for example, Jha (2003, p.287).

The first element is the promotion of exports (see section 5.2.3). Export growth can give an important contribution to productivity growth because it exposes domestic producers to the stringent test of foreign markets. Exports also play an essential role in the generation of healthy trade surpluses and the accumulation of foreign currency reserves. This protective cushion is needed to allow poor countries to maintain exchange rate stability and expand their policy freedom to implement non-mainstream economic strategies. In the absence of sufficient currency reserves poor countries would be compelled to seek undesirable forms of finance in the international markets or borrow from the international financial organisations, whose conditionalities would severely limit the scope for pro-poor and democratic economic policies.

Export growth requires a competitive exchange rate (see below) and co-ordinated industrial policy initiatives in order to develop competitive advantages in strategically important sectors.⁶⁵ The promotion of domestic industries involves the government in the complex task of ‘picking winners’, which has been addressed successfully in several East Asian countries through the establishment of performance criteria.⁶⁶ It goes without saying that these initiatives, and export promotion more generally, should avoid tilting incentives excessively towards the non-tradables sector. Although it is important to expand the production of non-tradables because of its greater flexibility, simpler technology and large employment-generating potential, the production of tradables is vital for the long-term progress of the country and the viability of its pro-poor development strategy.

The second element is the import policy. In spite of myths to the contrary, ‘openness and trade integration, either separately or together, do *not* have a

⁶⁵ See Amsden (1997, 2001) and Chang (1994).

⁶⁶ See Agosin and Tussie (1993), Chang (1993) and Gereffi and Wyman (1990).

measurable impact on long-run growth'.⁶⁷ Trade must be liberalised cautiously because of the differential impact of liberalisation on large or strategically significant economic sectors, and on the poor: 'it is incorrect to assume that trade liberalisation will automatically yield outcomes that are pro-poor, pro-jobs and pro-growth'.⁶⁸ Rather,

open trade is more a result of development rather than a prerequisite for it. As countries grow richer, they gradually take advantage of new opportunities offered by global trade. Trade follows development; it seldom leads development.⁶⁹

Rapid trade liberalisation and surging imports (especially if they are based on dumping strategies) should be avoided because of their potentially destabilising effects. In particular, vital economic sectors such as agriculture, construction and 'growth' industries must be protected from unbridled liberalisation. Regulation is important not only because of the potentially severe social and economic dislocations of import liberalisation, but also because historical experience shows that relatively autonomous late development is possible only if domestic industry and agriculture are protected.⁷⁰

A pro-poor trade policy has to be linked to a broader industrial strategy, including clear avenues for productivity growth and the development of domestic production capabilities in selected areas. Increased trade may foster growth through the transfer of technology (through investment projects, the purchase of blueprints or the technology embodied in imported capital goods), and it may create opportunities for the development of new industries. However, these effects are likely to be limited:

⁶⁷ Weller and Hersh (2004, p.492).

⁶⁸ Vandemoortele (2004, p.14).

⁶⁹ Vandemoortele (2004, p.14).

⁷⁰ See Chang (2002, 2003).

[T]he positive effects of liberalization disappear over time, which is a pattern consistent with deregulation euphoria in the early years of liberalization, followed by macroeconomic instability and lower growth.⁷¹

Import liberalisation could have a severe impact on the poor for three reasons. First, the benefits from trade can be concentrated in enclaves or increase the returns for skills or assets that are beyond the reach of the poor.⁷² Second, liberalisation may increase competition from low wage countries, reducing economic growth and the wages and employment opportunities of the poor. Third, heavily subsidised exports from rich countries (including grain, sugar, cotton, fruit, meat and dairy products) can undermine the viability of small-scale agriculture and the livelihood of millions of rural poor.⁷³ In their study of openness Weller and Hersh (2004) have concluded that

the income shares of the poor are lower in countries with deregulated current and capital accounts compared to more regulated ones. This is not because trade is directly harmful for the poor but because of the institutional design under which trade is conducted ... [T]he short-term adverse effects of current and capital account deregulation on the income shares of the poor are not offset by faster income growth in the long-run, which could raise the possibility of faster income growth for the poor ... [because] liberalization has no robust impact on growth rates. But ... trade may have a beneficial effect on the income shares of the poor in the short-run in a regulated environment ... [In sum,] countries where trade and capital flows [are] regulated ... do best for the poor.⁷⁴

⁷¹ Weller and Hersh (2004, p.499).

⁷² '[T]he net impact [of trade liberalisation] on employment opportunities depends on how far employment is gained or lost in shifting resources from the nontradable to the tradable sectors' (Pasha and Palanivel 2004, p.16).

⁷³ See Vandemoortele (2004, p.14).

⁷⁴ Weller and Hersh (2004, pp.499-500).

As was indicated above, pro-poor strategies require the regulation of the capital and financial account of the balance of payments. Capital account liberalisation can be extremely dangerous for poor and middle-income countries because of its potentially severe destabilising effects (see section 4.2). Unbridled liberalisation fosters the accumulation of excessive foreign debt, especially by banks, promotes speculative capital inflows that finance consumption more than investment, increases the country's vulnerability to balance of payments crises and facilitates capital flight.⁷⁵ In spite of the mainstream's insistence on capital account liberalisation, this strategy does not contribute to macroeconomic stability and, even if it raises the economic growth rate in the short-term, this effect tends to disappear in the medium-term. In this context, balance of payments instability is especially damaging for the poor:

The link between capital flows and incomes of the poor arises from a greater probability of financial crises in a liberalized environment. More capital flows, especially short-term portfolio flows, are often associated with a greater chance of financial crises ... [T]he burdens of financial crisis are disproportionately borne by a country's poor ... Although high-income earners are more likely to hold financial assets and hence to be hurt by a crisis through declining asset values, low-income earners may be more likely to be affected by declining demand as unemployment rises ... [A]t the same time that economic crises increase the need for well-functioning social safety nets, unfettered capital flows limit governments' abilities to design policies to help the poor when they need it most – in the middle of a crisis. The poor are the first to lose under such fiscal contractions, and the last to gain when crises subside and fiscal spending expands.⁷⁶

⁷⁵ See Palma (1998).

⁷⁶ Weller and Hersh (2004, pp.478-9).

Countries committed to a pro-poor development strategy must avoid capital account liberalisation for five reasons. First, as was explained above, capital controls support macroeconomic stability. Second, pro-poor strategies demand monetary policy autonomy (see section 5.3).⁷⁷ Third, they also require the state to direct investment and other resource flows to growth-promoting and poverty-reducing objectives (explained in sections 5.2.2 and 5.2.3), which may conflict with the short-term interests of the domestic and international financial sector. Fourth, and more prosaically, capital controls are necessary to curb tax evasion, since the tax rates required to fund pro-poor programmes will be higher than abroad. Without capital controls pro-poor macroeconomic strategies are simply impossible.

Several forms of capital control have been used recently by such diverse countries as Chile, Japan, Malaysia, South Korea and Sweden.⁷⁸ In these countries,

The use of controls has not resulted in interruptions of economic growth; on the contrary, when controls have been removed, as in Mexico in the early 1990s and in East Asia in the late 1990s, financial crises and severe economic downturns have been the result. Capital controls are not a fixed set of policies, and there are several different ways in which the flow of funds in and out of a country can be regulated ... Whatever form they take, *controls over the movement of funds across a country's borders are a necessary part of any general program of economic change*; without such controls, a government cedes the regulation of its economy to international market forces, which often means the forces of large internationally operating firms and powerful governments of other countries.⁷⁹

⁷⁷ 'The fixation with low inflation, on the part of even relatively successful countries such as China and Vietnam, stems partly from a concern about the potentially destabilizing effects of financial liberalization' (McKinley 2003).

⁷⁸ See, for example, Chang (2003), Chang and Grabel (2004, ch.9), Epstein, Grabel and Jomo (2003), Kaplan and Rodrik (2000) and MacEwan (2003).

⁷⁹ MacEwan (2003).

Forms of capital control can include, for example, restrictions on foreign currency bank accounts and currency transfers, taxes or administrative limits on outflows of direct and portfolio investment, restrictions on foreign payments for ‘technical assistance’ between connected firms, non-interest bearing ‘quarantines’ on investment inflows, controls on foreign borrowing and multiple exchange rates determined by the priority of each type of investment. These controls will impose an additional burden on the monetary authorities, but experience shows that the task is not beyond the capabilities of the central bank. The most significant obstacle to capital controls is *political*.

Having said all this, the choice of a pro-poor exchange rate regime is comparatively simple. The choice lies between fixed exchange rate regimes (including currency boards), adjustable pegs and ‘dirty’ floating (free floating regimes are simply too unstable to be seriously considered). In order to preserve macroeconomic stability small countries, often poor and with very concentrated trade patterns, and countries where currency substitution is very advanced may be forced to adopt fixed exchange rate systems. This is not ideal, because it reduces the scope for pro-poor monetary policy initiatives (see section 5.3), but it may be unavoidable in the short-term. In this case, the role of pro-poor fiscal policy becomes even more important.

Other countries may be able to count on additional degrees of freedom to adopt adjustable pegs or, even better, a ‘dirty’ floating exchange rate regime, which maximises the scope for monetary policy discretion. ‘Dirty’ floating creates the danger of real exchange rate instability, and the monetary authorities will need to beware of this risk.⁸⁰ Although exchange rate overvaluation can offer immediate

⁸⁰ ‘When there is a negative shock or boom ends, the country should have the ability to adjust its exchange rate downward. That is, it should adopt the real target approach. When the exchange rate is allowed to depreciate, a country also gains the ability to use fiscal-monetary policy to stabilize the economy and minimise the adverse effects on poverty’ (Chowdhury 2004b).

benefits to the poor through cheaper imports and lower inflation, this type of ‘exchange rate populism’ should be avoided. It can have destructive implications for the domestic productive base, in both industry and agriculture, and it can induce consumption and asset bubbles that may be difficult to neutralise. Experience suggests that export growth and the expansion of employment are more easily obtained with selective import protection, export incentives, capital controls and a *moderately undervalued exchange rate*.⁸¹ This may be achieved in different ways, including a relatively low currency peg (if this is relevant), expansionary monetary policies, the taxation and regulation of currency trading (especially in futures markets), capital controls and direct intervention in the currency markets.

5.2.5 – Social Programmes

Pro-poor economic strategies require specific policies and programmes to protect the poor and improve social welfare directly. Mainstream economic strategies claim that ‘trickle down’ and targeted social programmes can deliver significant benefits for the poor. However, this is not satisfactory by either social or economic criteria. It was shown in section 5.1 that adverse macroeconomic policies can overwhelm the impact of targeted programmes and, in mainstream strategies, they tend to contradict each other most of the time.⁸² In addition to this, targeted programmes are expensive to run, tend to miss out many potential claimants, are prone to corruption and allocation is always arbitrary at the margin:

⁸¹ Moderate exchange rate undervaluation finds strong support in the literature on trade and industrial policy; see, for example, Agosin and Tussie (1993), Chang (1994) and Gereffi and Wyman (1990).

⁸² ‘[A] country’s strategy of development and its associated macroeconomic policies can have as much effect as – and in many cases more effect than – targeted interventions. In fact, if the country’s development strategy and macroeconomic policies continuously reproduce poverty, targeted interventions can do little to reverse the situation’ (McKinley 2001).

Narrowly targeted programmes are increasingly prescribed for reasons of efficiency and cost savings – for they claim to minimise leakage to the non-poor ... As far as basic services are concerned, narrow targeting can have huge hidden costs. They result from the fact that it is often difficult to identify the poor and to reach them because the non-poor –most of who remain ‘near-poor’ – seldom fail to capture a large part of subsidies destined for more destitute people. Also, administering narrowly targeted programmes is at least twice as costly as running untargeted ones. In addition, the poor must frequently document eligibility—which involves expenses such as bus fares, apart from the social stigma they generate. Such out-of-pocket costs can be a real obstacle. Most importantly, however, is the fact that once the non-poor cease to have a stake in narrowly targeted programmes, the political commitment to sustain their scope and quality is at risk. The voice of the poor alone is usually too weak to maintain strong public support.⁸³

In order to maximise their pro-poor impact these policies and programmes should prioritise the provision of *public goods* and the *social wage*, rather than monetary handouts. Social programmes including the provision of public education, training and health provision, housing, water and sanitation, parks and public amenities, environmental preservation, the promotion of food security, and affordable clothing, shoes and public transportation can have relatively low managerial costs and they improve the standard of living of the poor directly:

These [social] programs meet people’s basic needs, contributing to the reduction of poverty and to the equalization of the income distribution; they thus generate immediate benefits. Many of these programs ... contribute to people’s productivity, laying a foundation for more successful, long-term economic expansion. The production process to

⁸³ Vandemoortele (2004, p.12).

create and operate social programs is often labour intensive, and thus their implementation tends to use the resource most abundant in low and middle income countries and, which is to say the same thing, tends to be employment-creating. The expansion of social programs generally does not require large amounts of foreign exchange, but can be undertaken mostly with domestic resources; it therefore does not excessively aggravate the foreign exchange problem ... Often these programs can be shaped in ways that directly and indirectly contribute to the development of democratic participation, which is valuable in itself and strengthens the foundation of change.⁸⁴

In many countries, the required administrative infrastructure is already in place, or it can be created at a relatively low cost. These programmes are also allowed by WTO rules as long as they do not discriminate between domestic products and imports.

Public and social wage goods programmes can be rolled out gradually (e.g., one product or service at a time), making them relatively cheap and easy to run. They also include many of the advantages of targeted programmes, in spite of their universal coverage, which may be called ‘smart targeting’: public and wage goods programmes are *universal* because they are available to all, and they are also *targeted* because distinct social groups will be affected differently by each project or initiative. For example, subsidised staple foods sold in shops in poor areas (as in India) are available to all – but, in practice, the programme targets the poor both through its choice of product and the geographically limited availability of the staples, which will naturally exclude most of the non-poor. The precise balance between the targeted and universal aspects of the provision of public and wage goods depends on policy decisions about access and the nature of each project.

⁸⁴ MacEwan (2003). For Vandemoortele (2004, p.12), ‘[s]ince basic services are public goods with strong synergies and positive externalities, they should be either free or heavily subsidised – regardless of whether they are provided by public, private or non-governmental agencies’.

Finally, public and social wage goods programmes can be criticised because they may lead to overconsumption (e.g., free health services could foster trivial complaints or unnecessary prescriptions), or manipulation by unscrupulous politicians. This is certainly possible (although it can be minimised by universal access and ‘smart targeting’, see above). However, the commercialisation of health or education is not the only possible alternative. These potential problems can also be addressed through the *expansion of democracy* and *public control of the state*.

Cash transfers are generally less desirable than public and social wage goods programmes except for emergency support to very poor groups and long-term assistance to dependent children, the elderly, and the chronically sick and disabled. Cash transfers are limited for cost, efficiency and equity reasons. First, it is usually cheaper to provide basic public goods centrally through state provision rather than privately, via cash transfers. The managerial costs tend to be lower, their quality is more uniform and, as long as provision is controlled democratically, corruption can be avoided more easily. Second, cash transfers are a form of targeting, which is relatively inefficient (see above).⁸⁵ Third, cash transfers imply that social welfare is determined by the individual capacity to purchase private goods, rather than the availability of public goods. Transfers foster the commodification of social life and the development of competition, which conflicts with the social solidarity engendered by pro-poor policies. In contrast, public goods and social wage programmes ensure the provision of key goods and services to all, contribute to the de-commodification of the social relations, and foster the development of community relations.

⁸⁵ Universal basic income is the only type of non-targeted cash transfer, but it is unaffordable for most poor countries, and hardly the best use for their scarce resources. It is also vulnerable to the other criticisms of cash transfers listed above.

All social programmes are expensive to run, and the budgetary limitations in poor countries should not be underestimated. However, these programmes can have a significant distributive impact. They can also contribute to other pro-poor objectives – for example, they create employment at local level, they can be plugged into regional development programmes through the creation of markets for local produce, and they can be linked to the expansion of infrastructure (e.g., through public works programmes).⁸⁶ In spite of these advantages, funding is likely to pose severe problems. In general these programmes should be funded by taxation. Cost-sharing or user fees, while not ruled out on principle, can be socially unfair and extremely inefficient, and should normally be avoided:

While narrow targeting, user fees, and social investment funds can play a role, they can never be the mainstay of a country's anti-poverty strategy. In most contexts, they are likely to yield savings that are penny-wise but pound-foolish ... Despite the very modest amount of money they generate, user fees invariably lead to a reduction in the demand for services, particularly among the poor. Attempts to protect the poor – through exemptions or waivers – are seldom effective, although often expensive. The introduction of user fees also tends to aggravate gender discrimination ... Since the mid-1990s, school fees have been abolished in Malawi and Uganda and more recently in Kenya. That pro-poor policy was followed by a surge in enrolment in all three countries – with girls being the prime beneficiaries. These positive experiences illustrate that even a small nominal fee can be a formidable obstacle for poor families.⁸⁷

The political process is central to the success of pro-poor social programmes. On the one hand, their implementation requires breaking the political power of the traditional elites committed to inequality through the development of universal

⁸⁶ See, for example, Dagdeviren et al (2002, pp.401, 404).

⁸⁷ Vandemoortele (2004, p.12).

citizenship. In fact, budgetary transfers tend to be insufficient dent poverty when the distribution of assets is highly unequal. In these circumstances, democratic political and economic reforms, including the distribution of assets, are essential. On the other hand, these programmes would benefit from direct user participation, which will increase the scope for democratic participation and intervention in the economy.

In conclusion, the implementation of pro-poor economic programmes depends less on their internal consistency (which has nevertheless been indicated above) than on political limitations. More specifically, the most important constraint to the introduction of pro-poor strategies in poor countries is not resource scarcity. Rather, it is the lack of political will to confront the mainstream and build alternatives based upon the joint efforts of governments and civil society organisations.

5.3 – Pro-Poor Anti-Inflation Policy

This section outlines the basic principles of pro-poor anti-inflation policy alternatives to the NMPC. It was shown in sections 1-3 that the NMPC suffers from serious theoretical and empirical shortcomings and, in section 4, that these flaws are especially severe in poor countries. Sections 5.1 and 5.2 outlined the basic features of pro-poor economic development strategies for middle-income and poor countries. This section extends these suggestions into the fields of monetary and anti-inflation policy.

Growing economies normally experience inflation. Mainstream economic theory claims that inflation control is the most important objective of monetary policy because it fosters investment and growth. For the NMPC, inflation control should be achieved primarily through contractionary monetary policy, that is, high interest rates. They should be supported by additional policies, including fiscal retrenchment, privatisations, trade, financial and capital account liberalisation and additional macroeconomic ‘reforms’ aiming to consolidate a specific

(mainstream) development strategy. It was shown above that this strategy is rarely conducive to sustained growth, macroeconomic stability or pro-poor outcomes.

There is no question that high interest rates can give a decisive contribution for the elimination of hyperinflation; they can also maintain very low inflation for long periods. However, high interest rates are incompatible with pro-poor policies because they stifle growth, transfer income to finance and cancel out the potential benefits of expansionary fiscal policy.

Both very low and very high inflation are inimical to pro-poor outcomes because they are associated with low growth rates and arbitrary and potentially regressive distributive shifts. Low or moderate inflation are more easily compatible with growth because they facilitate the adjustment of relative prices, support the transfer of resources to more profitable sectors, and assist the financing of productive investment. However, this does not ensure the achievement of pro-poor goals. This section outlines monetary policies that can support inflation stabilisation and pro-poor economic strategies, and contrasts them with CBI and IT.

5.3.1 – Principles of Pro-Poor Anti-Inflation Policy

Pro-poor anti-inflation policies support the government's pro-poor strategy by helping the economy to avoid very low, very high or rapidly accelerating inflation. Following the principles outlined in section 5.1.3, pro-poor anti-inflation policy needs to be *efficient*, *sustainable* and *support the achievement of MDGs*.

In order to be *efficient*, pro-poor monetary and anti-inflation policies require government co-ordination and social co-operation (see section 5.3.3). To be *sustainable*, they need to be internally consistent. These policies should aim at clearly defined goals that are part of the government's pro-poor strategy. These goals should be mutually compatible, and they should be achievable given the available resources and policy instruments. The available tools should be

deployed consistently, that is, they should be suitable to their stated goals, and they should not generate unwarranted economic dislocations or send contradictory signals to the markets. In this way state policies can best attract the co-operation of private actors, including the workers, entrepreneurs and civil society organisations.⁸⁸

Finally, pro-poor anti-inflation policies must *support the achievement of MDGs*, subject to the constraint of macroeconomic stability. At a macroeconomic level, these policies should help to maintain low interest rates, low inflation, long-run fiscal and balance of payments equilibrium and exchange rate and financial stability, including the minimisation of cycles and bubbles. At a microeconomic level, they should support the government's industrial policies through targeted credit for priority sectors, the management of the country's capital controls, and the regulation of private activity with a view to garnering financial system support for the government's objectives.

These monetary policy goals are incompatible with nominal targets or anchors, which would compromise the consistency of these pro-poor strategies. This does not deny the importance of low inflation for economic stability. However, it does mean that in the absence of a natural rate of unemployment and given the democratic selection of a pro-poor strategy, low inflation cannot be the only or the most important government policy objective.⁸⁹ Unless government actions clearly focus on MDGs, their achievement will become increasingly unlikely. In this framework, nominal indicators of economic stability offer benchmarks and guidelines for government policy, but they are not to be targeted.

⁸⁸ See Sicsú (2001, p.673).

⁸⁹ See Forder (2003, p.12).

5.3.2 – Policy Tools

The interest rates should not be saddled with the twin objectives of controlling inflation and achieving balance of payments equilibrium. It was shown in section 3.3 that this double role tends to raise the interest rates to excessively high levels, and it can be destabilising. Section 5.2.4 has shown that, with the introduction of capital controls, the interest rates will no longer play an essential role in the stabilisation of the balance of payments. This does not imply that they are freely available for inflation control, quite the contrary. Monetary policy should serve broad pro-poor objectives, specifically the allocation of resources across different sectors of the economy, the regulation of domestic savings and investment and real exchange rate stability. The interest rates may contribute to demand control but only exceptionally, if economic stability is impaired.

Lower interest rates will support the expansion of domestic economic activities and relieve the government budget through the reduction of interest payments on the domestic public debt. They will release resources for economic development objectives through higher levels of public and private investment, supported, if necessary, by the regulation of the financial system.⁹⁰ In turn, the rentiers will be penalised directly through higher taxation, and indirectly through lower returns on their financial investments. Attempts to evade these restrictions through capital flight should be penalised severely.⁹¹

This change in the economic role of the interest rates calls for a different anti-inflation policy architecture. This policy should be based on three main

⁹⁰ Argitis and Pitelis (2001, p.633) have shown that lower interest rates can raise the industrial profit share, reduce production costs and inflation and improve competitiveness. This less restrictive economic environment promotes investment, productivity and growth.

⁹¹ '[M]ost successful development experiences were associated with the subordination of finance (through a variety of means) to the objectives of economic development' (Chang and Grabel 2004, p.184).

instruments: fiscal policy, industrial policy (for productivity growth), and social co-operation through centralised bargaining.

It was shown in sections 5.2.2 and 5.2.3 that fiscal policy fulfils several critically important roles in pro-poor development strategies. It assists economic stabilisation, supports public investment, crowds in private investment, supports technological upgrading and employment generation projects and funds social programmes, among other objectives. However, in contrast with interest rate policy, fiscal policy is *vertical*: it can be easily targeted towards different sectors, social groups or areas of the economy, and its impact is both rapid and unmediated. This makes it more powerful than monetary policy and easier to control. Its distributive implications are also more transparent. Therefore, the fiscal policy stance can be adjusted with less significant implications for the government's pro-poor goals. For example, if a fiscal contraction becomes necessary, it could be either linear (as a change in interest rate would be) or it can be concentrated on specific programmes or regions. The implications of the policy change are transparent, which will facilitate the democratic debate about its convenience and opportunity. In contrast, the microeconomic impact of monetary policy changes is unclear, making targeting impossible and debate less fruitful. Finally, fiscal policy manipulation depends to a lesser extent on the degree of financial market development, and it can be implemented more independently by the government.

While fiscal policy calibrates the government's efforts to control inflation, centralised bargaining will address other potential sources of inflation through the creation of solidaristic mechanisms of wage-setting and the co-ordination of conflicting demands on the national product (presuming, of course, that the government is simultaneously addressing the question of asset distribution). Finally, industrial policy will foster productivity growth, increasing the size of the 'cake' to be shared. Productivity growth is strongly anti-inflationary because it can permanently defuse distributive conflicts and foster social co-operation (see section 5.3.3). Other policy instruments may be used to support this policy triad;

for example, changes in tax policies, tariffs and other trade barriers, credit limits, price controls (especially in public utilities industries) and even – but only marginally and temporarily – exchange rate policy.

5.3.3 – Policy Co-ordination and Social Co-operation

Government policy co-ordination and social co-operation play important roles in the success of pro-poor anti-inflation policies at different levels.

First, *co-ordination between state institutions*. This problem cannot be addressed here. It will simply be assumed that it can be achieved through legislation, careful choice of personnel and competent management (see, however, the note about the structural deficiencies in the state apparatus of poor countries in section 5.1.3).

Second, *co-ordination of economic policies*. It was shown in section 5.3.2 that pro-poor anti-inflation programmes do not rely on one single policy. Rather, they require the co-ordinated deployment of a broad range of policies, among them fiscal, monetary, incomes, price, industrial and exchange rate policies in order to address the causes of inflation rather than its symptoms or propagation mechanisms. Each of these policies contributes in a specific way to the achievement of pro-poor goals and macroeconomic stability. Combining a wide variety of policies facilitates the involvement of society in the pursuit of low and stable inflation. In the absence of a social commitment to macroeconomic stability governments will be forced to deploy blunt instruments with insufficient information, possibly against unwilling social sectors. This will increase the cost of inflation control and, in all likelihood, reduce the welfare of the majority.

Third, *co-ordination between the state and other social sectors*. This is more complicated, and different types of incentives will be required to obtain the co-operation of reluctant social groups. This is not simply a question of pleading for the idealism of the population, or hoping that the selfless dedication of a few individuals will deliver the required macroeconomic outcomes. Legal, political

and economic incentives should be deployed to reward compliant behaviour and punish deviant economic practices. At the same time, civil society organisations will mobilise in defence of their own interests and the pro-poor objectives of the government's programme. Evidently, social co-operation is more easily created through the democratic involvement of the citizens in economic policy-making and the implementation and assessment of government policies.⁹²

In sum, low inflation can be achieved at an acceptable social cost, but this requires more than just controlling the supply of money or jacking up interest rates as much as necessary to deliver arbitrary inflation targets. Low and stable inflation is the outcome of a social commitment to price stability that is part of a pro-poor policy compact. It cannot be delivered simply by central bank fiat. Co-operation and co-ordination can foster an environment in which society is committed to low inflation, where economic behaviours are broadly compatible with this objective, and where government policy contributes decisively to its achievement. They will reduce the scope and the need for central bank discretionary action, especially arbitrary changes in interest rates that create uncertainty, deter investment, generate unemployment, and impose obstacles to the achievement of MDGs (see section 5.3.4). In a pro-poor policy framework, inflation control is not the province of one single government institution; it is a national objective, supporting the achievement of MDGs.

5.3.4 – Inflation Targeting, CBI and Pro-Poor Anti-Inflation Policy

In what follows, it will be argued that pro-poor strategies are incompatible with the NMPC. In order to facilitate policy co-ordination and the mobilisation of monetary and anti-inflation policy tools for the achievement of MDGs, ITR

⁹² '[S]ocial co-operation and social consensus would have to be created by involving people in the process itself: There is, of course, the experience of some ... countries which have been conspicuously successful with economic policies that relied on social consensus (Sweden, Norway, Australia and Austria are the best examples in this respect)' (Philip Arestis, cited in Sicsú 2001, p.676); see also Arestis and Sawyer (2002).

should be *abandoned* where they have been implemented, and central bank independence must be *curtailed*.

From a pro-poor point of view the NMPC is either inconsistent or misguided at several levels. First, the NMPC is theoretically inconsistent, because there is no guarantee that a single interest rate can simultaneously deliver low inflation (through demand control), low unemployment, exchange rate stability, balance of payments equilibrium and a sustainable fiscal position (see section 3.3).

Second, the NMPC turns very low inflation – a *means* to growth and welfare improvement – into the most important macroeconomic policy *objective*. This is analytically untenable because the tail (inflation) is wagging the dog (economic growth and social welfare). This policy arrangement also reduces accountability in the economy. The real goals of economic activity are transferred to the market, that is, beyond the scope of democratic debate, intervention and monitoring. In contrast, pro-poor policies focus directly on the desirable *outcomes*.

Third, inflation targets are incompatible with pro-poor goals because they (just like *any other* nominal target) compel monetary policy to throttle demand unthinkingly whenever inflation rises above an arbitrary – and invariably very low – target level. This strategy can maintain very low inflation, but only at a high cost and at the expense of long-term equitable growth and the *real* pro-poor targets in MDGs. It was shown in sections 3 and 4 that IT is inefficient (its economic and social cost is too high), socially regressive (it fosters the concentration of income and the transfer of power to finance) and macroeconomically unsustainable (it is not conducive to long-term growth and it can trigger stabilisation traps).

Pro-poor anti-inflation policies do not simply involve greater tolerance to inflation with the expectation of achieving, in return, faster GDP growth rates. Positing this non-existing trade-off as if it were real (see section 2.2.1), for example, through the argument that the IT should be ‘relaxed’, would be both insufficient and wrong. It would be wrong because it implicitly accepts the mainstream theory of

inflation that informs the NMPC – it admits the real-monetary dichotomy, the existence of a short-run Phillips curve, CBI and so on. This is unacceptable. It would also be insufficient, because it would simply replicate the shortcomings of IT at a higher level of inflation.⁹³ If implemented, this ‘limited surrender’ would simply offer an easy target to attack, create inflation inertia and entrench high inflation expectations.

It was shown in section 5.1.4 that nominal targets or anchors are inimical to pro-poor goals, and that governments committed to these goals should not introduce any specific policy constraint (such as maximum inflation rates) that may create the expectation of paralysis or policy reversal at a later stage. Volunteering nominal limits to government programmes would offer clear aims for those negatively affected by the government’s pro-poor priorities. It would tempt them to confront the government, and simplify their destructive task.

Pro-poor policies are also incompatible with CBI because, first, the central bank is unable to control inflation on its own (there is no real-monetary dichotomy, see section 2.1). Second, the government should be able to count on all available instruments to achieve its pro-poor objectives rapidly and efficiently, while seeking to preserve macroeconomic stability. If, through CBI, monetary policy lies outside the scope of central government policy-making, policy co-ordination becomes more difficult and social co-operation will become elusive:

⁹³ ‘One might perhaps hope for a modified independence where the central bank is not expected to target price stability exclusively, but rather to follow some other, more sophisticated, rule. The design of such a rule is, however, all but impossible. The circumstances of events like possible financial collapse, government default [and] sharply increased protectionist pressures ... are unusual, if not unique, and an unavoidable element of the political, bringing uncertainty with it, is present in them all ... To imagine that ideal policy will be the outcome of any particular institutional structure in circumstances like these is optimistic; but to imagine that even good policy can be determined by a rule in advance of knowing what the conditions are is much more problematic still ... Difficult as it is to know how to construct institutions for reasonable policy, the supposition that even acceptable policy will always be achieved by aiming exclusively at the maintenance of price stability verges on the absurd’ (Forder 2003, pp.17-18).

Independent central banks are incompatible with principles of democratic governance, particularly because monetary policy has such profound distributional and macroeconomic effects.⁹⁴

In addition to this, conflicts between the government and the central bank will increase the complexity, costs and delays of the pro-poor programme democratically selected by the citizens.

In order to achieve these social goals the central bank needs to be *accountable* and *fully committed* to the government's strategy, controlling the monetary policy tools with a view to delivering low interest rates, stable exchange rates, minimum unemployment levels and low and stable inflation. This is the bank's contribution to the achievement of MDGs:

Clear, transparent objectives for monetary policy ... should be established, and central banks should work with the government to achieve identified developmental objectives ... Taking a page from the neoliberal book, monetary policy should have targets. But instead of concentrating on inflation, monetary policy targets should comprise broader economic and social welfare goals. In this connection, monetary policy targets can seek to promote economic growth, employment and equality. The prevention of high rates of inflation should be pursued only as far as is consistent with these broader goals.⁹⁵

Accountability to the public and commitment to democratically-determined goals are the keys to institutional *transparency* and *credibility* within a pro-poor strategy. These principles apply to *all* government institutions, not just the central

⁹⁴ Chang and Grabel (2004, p.183).

⁹⁵ Chang and Grabel (2004, p.187).

bank. They are part of the framework of political democracy, and they are essential building blocks for the construction of economic democracy.

Conclusion

IT and CBI are not merely technical matters, as the mainstream tends to believe. This policy framework has profound implications for the economy, society and the political system. The alternative pro-poor monetary policy framework outlined in this research paper also has implications at these three levels. The choice between them involves not only their internal consistency (which was demonstrated for the pro-poor alternatives, but shown to be lacking in the case of the NMPC). It also involves a choice between significantly different economic, social and political outcomes for each country.

The NMPC is flawed in two important senses. First, it is based on an array of doubtful assumptions about the economy, wild generalisations from a very small number of cases and overly optimistic expectations about the convergence of the economy to a virtuous circle of growth and prosperity that tends to be elusive. In spite of these deficiencies IT and CBI can contribute to inflation control, both because governments will always set targets that they believe can be achieved,¹ and because demand control through high interest rates can reduce inflation regardless of its causes, especially in an open economy. In this sense, the main problem with conventional disinflation policies, including the NMPC, is not that they fail to achieve their stated aims. Rather, it is that they are blunt and inefficient, grinding down inflation through long periods of high unemployment, and reducing the economy's growth potential in the process. Second, the hyper-vigilance against inflation associated with IT and CBI tends to be incompatible with rapid and equitable growth, and it is inimical to economic democracy because it fosters the interests of finance at the expense of the majority of the

¹ In this sense, achieving a target may be a reflection of good forecasting of the outturn which was used in setting the target, rather than the 'discipline' or 'purposefulness' of the monetary authorities, or the 'correction' of their theoretical approach to economic policy-making (see Arestis and Sawyer 1998a).

population. Moreover, these policy regimes create institutional rigidities that will make it difficult to shift economic policies in the future.

It is impossible to predict how these shortcomings will eventually pan out. They will probably not appear either through a renewed bout of inflation or through the inability of IT and CBI to flush out residual inflation from the economy (which was one of the symptoms of the failure of monetarism in the eighties). The current consensus will probably be abandoned for *political* reasons, especially because it is excessively costly and locks countries into a development strategy that is socially and economically regressive, *regardless of its ability to deliver low inflation*. In this case, there will be great demand for pro-poor and democratic monetary policy alternatives.

This research paper does not offer a completely worked-out policy framework, although it does offer a fairly comprehensive critique of the NMPC. Further work is essential, because it will become possible to intervene in policy debates and mobilise support much more effectively on the basis of *positive* contributions rather than merely negative critiques. This is especially urgent because IT and CBI have yet to survive a severe test – the economic environment since the late eighties has been far too benign to impose a serious challenge to the ruling policy paradigm. History shows that these favourable circumstances will not last forever.

Appendix A

Figure A1: Models of Central Bank Independence and Inflation Targeting

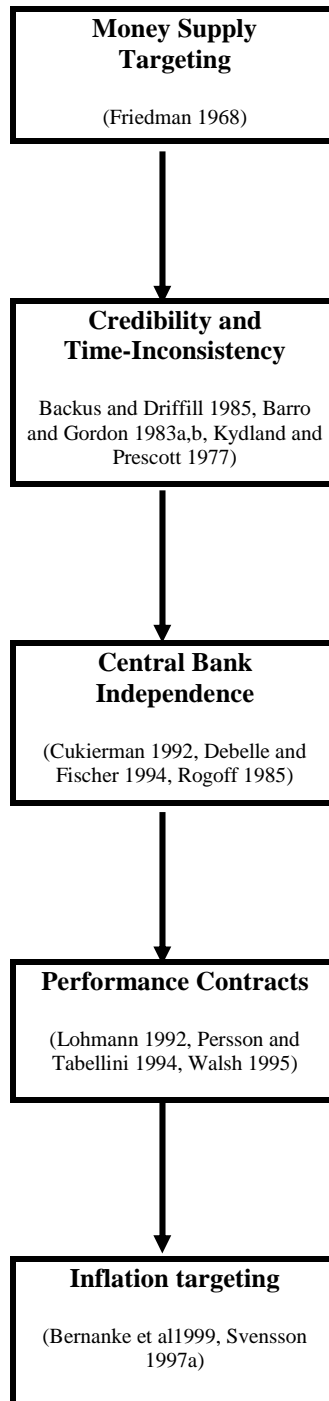


Figure A2: Inflation Control in the NMPC

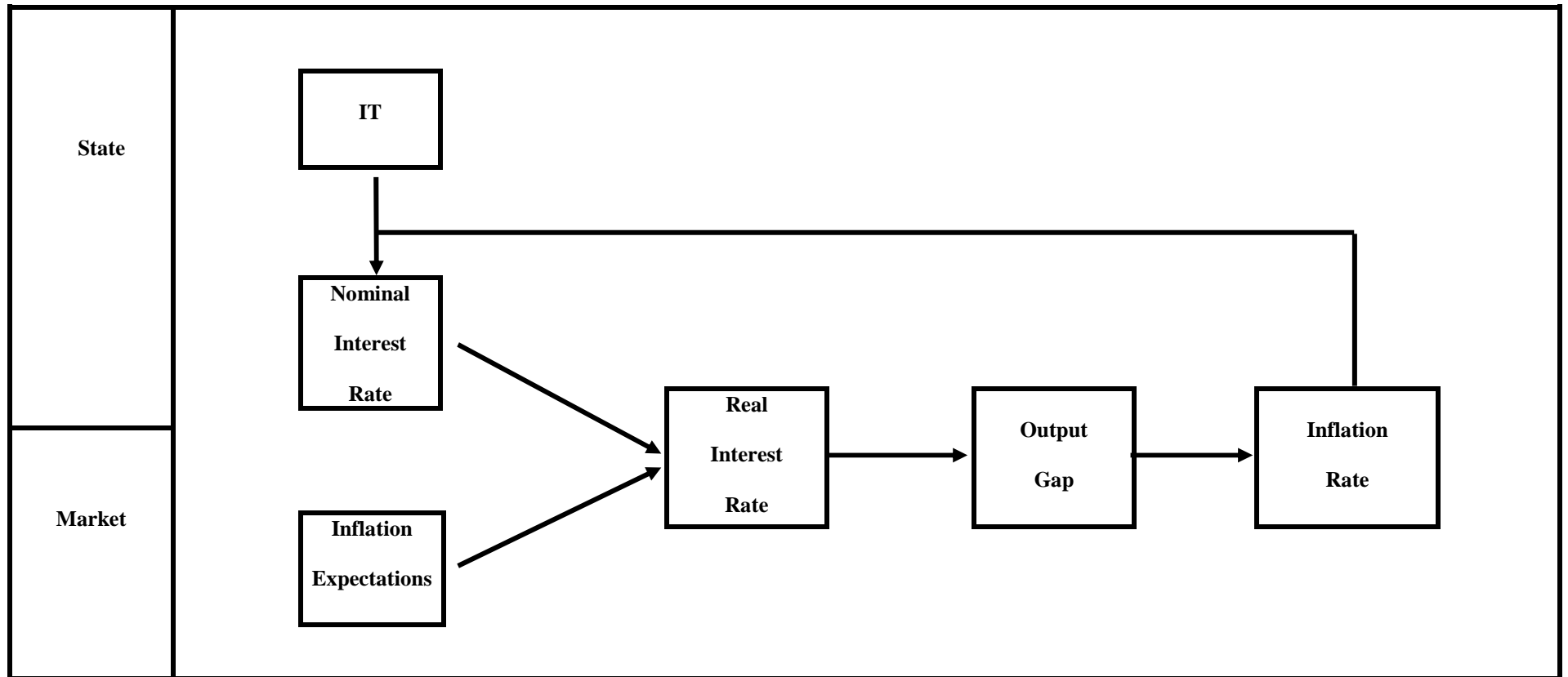


Table A1 – Inflation Targeting Regimes in 2003

FFIT	EIT	ITL
Australia	Euro Area	Albania
Brazil	Japan	Algeria
Canada	Singapore	Croatia
Chile	Switzerland	Dominican Republic
Colombia	United States	Guatemala
Czech Republic		Honduras
Hungary		Indonesia
Iceland		Jamaica
Israel		Kazakhstan
Mexico		Mauritius
New Zealand		Peru
Norway		Philippines
Poland		Romania
South Africa		Russia
South Korea		Slovakia
Sweden		Slovenia
Thailand		Sri Lanka
United Kingdom		Uruguay
		Venezuela

Source: Carare and Stone (2003). Stone and Bhundia (2004) include Peru and the Philippines among the FFIT countries, and Argentina, Egypt, Iran and Turkey among the ITL countries; they also claim that Honduras, Uruguay and Venezuela are exchange rate targeters rather than ITL.

Appendix B

Box B1 – Classification of Countries

The information included in this paper is based on the data provided by the World Bank (2003). The World Bank supplies information about 208 countries and economic areas. This paper excludes 56 small countries and regions with populations below one million in 2001,³⁰⁴ seven countries and regions for which there is insufficient data,³⁰⁵ and Puerto Rico (because of its close economic and political links with the United States).

The remaining 144 countries were distributed into twelve groups on the basis of their geographical position, income level and long-term growth rates:

- **21 Rich Countries (RICH):** Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States. Data available for 1961-2001, except Canada (since 1966) and Germany (since 1972).
- **14 Eastern European and Central Asian High Income Countries (EECA-HIGH):** Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Russia, Slovakia and Slovenia. Data available for 1991-2001, except Bulgaria and Estonia (from

³⁰⁴ American Samoa, Andorra, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, Bhutan, Brunei, Cape Verde, Cayman Islands, Channel Islands, Comoros, Cyprus, Djibouti, Dominica, Equatorial Guinea, Faeroe Islands, Fiji, French Polynesia, Greenland, Grenada, Guam, Guyana, Iceland, Isle of Man, Kiribati, Liechtenstein, Luxembourg, Macao, Maldives, Malta, Marshall Islands, Mayotte, Micronesia, Monaco, Netherlands Antilles, New Caledonia, Northern Mariana Islands, Palau, Qatar, Samoa, San Marino, Sao Tome and Principe, Seychelles and Solomon Islands

³⁰⁵ Afghanistan, Bosnia and Herzegovina, Cuba, Iraq, North Korea, West Bank and Gaza and Yugoslavia.

1981), Hungary (from 1961), Latvia (from 1966), Russia (from 1990), Slovakia (from 1985) and Slovenia (from 1992).

- **12 Eastern European and Central Asian Low Income Countries (EECA-LOW):** Albania (1981-2001), Armenia (1991-2001), Azerbaijan (1993-2001), Georgia (1966-2001), Kazakhstan (1990-2001), Kyrgyz Republic (1987-2001), Moldova (1990-2001), Mongolia (1982-2001), Tajikistan (1986-2001), Turkmenistan, Ukraine and Uzbekistan (1988-2001).
- **8 East Asian Fast Growth Countries (EA-FAST):** China, Hong Kong, Indonesia, Korea, Malaysia, Singapore, Thailand and Vietnam. Data available for 1961-2001, except Vietnam (from 1986).
- **4 East Asian Slow Growth Countries (EA-SLOW):** Cambodia, Laos, Papua New Guinea and Philippines. Data available for 1961-2001, except Cambodia (from 1988) and Laos (from 1985).
- **6 South Asian Countries (SASIA):** Bangladesh, India, Myanmar, Nepal, Pakistan and Sri Lanka. Data available for 1961-2001.
- **12 Latin American High Income Countries (LA-HIGH):** Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Mexico, Panama, Paraguay, Trinidad and Tobago, Uruguay and Venezuela. Data available for 1961-2001.
- **9 Latin American Low Income Countries (LA-LOW):** Bolivia, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Nicaragua and Peru. Data available for 1961-2001.

- **5 Sub-Saharan African High Income Countries (SSA-HIGH):** Botswana, Gabon, Mauritius, Namibia and South Africa. Data available for 1961-2001, except Mauritius and Namibia (from 1981).
- **37 Sub-Saharan African Low Income Countries (SSA-LOW):** Angola, Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo D.R., Congo R., Cote d'Ivoire, Eritrea, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia and Zimbabwe. Data available for 1961-2001, except Angola (from 1986), Eritrea (from 1993), Ethiopia (from 1982), Gambia (from 1967), Guinea (from 1987), Guinea-Bissau (from 1971), Mali (from 1968), Mauritania and Mozambique (from 1981), Swaziland (from 1971), Tanzania (from 1989) and Uganda (from 1983).
- **9 Middle-Eastern and North African Non-OPEC Countries (MENA-NO):** Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, Turkey and Yemen. Data available for 1961-2001, except Jordan (from 1976), Lebanon (from 1989), Tunisia (from 1962), Turkey (from 1969) and Yemen (from 1991).
- **7 Middle-Eastern and North African OPEC Countries (MENA-OIL):** Algeria, Iran, Kuwait, Libya, Oman, Saudi Arabia and United Arab Emirates. Data available for 1961-2001, except Iran (from 1975), Kuwait (1963-89 and 1993-2001), Libya (until 1987) and United Arab Emirates (1974-98).

Box B2 – Economic Growth Rates

Table B2.1 and Figures B2.1-B2.6 show an unambiguous trend towards declining per capita GDP growth rates in most countries during the last four decades.

- **RICH:** These countries generally show relatively high growth rates until 1973, and declining rates afterwards. Growth rates in New Zealand were relatively slow and highly volatile between the mid-sixties and the mid-seventies, but they have converged to the general pattern since the early eighties. Japan is another outlier, with very strong growth rates until the early seventies, and in the late eighties, but generally declining growth rates afterwards. Ireland shows a different pattern, with strong growth rates during the entire period, but rising since the late eighties.
- **EECA-HIGH:** Per capita GDP growth rates in these countries declined very severely between the late eighties and the mid-nineties, but started rising strongly subsequently. The most dramatic decline was in Latvia, where per capita GDP fell by 10.1 per cent in 1991, 34.1 per cent in 1992, and 13.4 per cent in 1993, but it started growing strongly after 1996 (the performance of Estonia is similar). The mildest decline was in Poland (followed by Slovenia), where per capita GDP fell 7.3 per cent in 1991 (the first year in the series), but grew in every subsequent every year.
- **EECA-LOW:** The pattern in these countries is similar to EECA-HIGH, but the decline was more severe. Per capita GDP in Georgia fell 7.7 per cent in 1989, 15.0 per cent in 1990, 21.1 per cent in 1991, 44.8 per cent in 1992, 29.1 per cent in 1993 and 10.2 per cent in 1994, but it has grown steadily since then. Armenia shows a similar but less severe decline, followed by Albania, Moldova and Tajikistan, where per capita GDP tumbled by at least 30 per cent

in one single year. In all other countries per capita GDP fell by at least 10 per cent in one year, but all these economies later rebounded.

- **EA-FAST:** These countries show a very strong economic performance, but growth has generally been volatile during the entire period. China's performance has been consistently strong since 1963, and volatility has declined especially since the early nineties. China and Vietnam were the only countries spared the ravages of the Asian crisis (that afflicted Indonesia especially severely) and the collapse of the dotcom bubble at the turn of the millenium (which penalised Singapore more than other countries).
- **EA-SLOW:** Performance in these countries has been highly volatile during the entire period, especially in Papua New Guinea where growth peaked at 15.2 per cent in 1993, but the country also had fifteen years of negative growth during the period under analysis. Growth in the Philippines has also been disappointing, with a clear stop-and-go pattern. Cambodia and, especially, Laos show a more promising pattern, which resembles EA-FAST.
- **SASIA:** Growth has been moderate but highly volatile in these countries, especially in Myanmar and Nepal. The economic performance of Pakistan has deteriorated significantly during the nineties, after relatively strong growth between the mid-seventies and the late eighties. The nineties were relatively good (though not especially good by East Asian standards) for Bangladesh, India and Sri Lanka.
- **LA-HIGH:** Some of these countries had an outstanding growth performance until the early eighties, especially Brazil (where per capita incomes have almost stagnated afterwards) and Mexico (where it resumed, albeit more slowly, and with the exception of the crisis period in the mid-nineties). The Dominican Republic also grew strongly until the early eighties and after the

mid-nineties. Growth in Chile was also very strong between the mid-eighties and the mid-nineties. In contrast, income growth was disappointing or non-existent in Argentina, Colombia, Paraguay and Venezuela, especially after the early eighties. In the remaining countries (Costa Rica, Panama, Trinidad and Tobago and Uruguay) growth was volatile but generally positive during the entire period, in spite of a declining trend since the late seventies.

- **LA-LOW:** The growth performance in these countries has not been especially good. Incomes have virtually stagnated in most countries since the mid-seventies, and growth has generally been volatile during the entire period.
- **SSA-HIGH:** Performance has not been especially strong in these countries. Gabon grew exceptionally strongly in the mid-seventies (up to 34.8 per cent in 1974), but stagnated afterwards. Namibia and South Africa have barely grown at all for many years. Only Botswana and Mauritius show a steady growth performance.
- **SSA-LOW:** Growth performance in this region has been generally poor and highly volatile. Several countries have been afflicted by internal or external conflict, or by HIV-AIDS, with severe implications for their economic performance. Many of these countries are among the poorest in the world, and their debt burden is often very high. There is a clearly declining per capita GDP growth trend throughout this period. Several countries show significant declines in their income levels, e.g., Liberia, where growth rates were strongly negative every year between 1980 and 1995.
- **MENA-NO:** These countries had a volatile and not especially strong growth performance during the entire period, in particular Jordan, Lebanon, Morocco and Syria. However, volatility seems to have declined significantly since the

late seventies. Income growth in Egypt and Turkey has been especially strong during this period.

- **MENA-OIL:** Growth in these countries has been extraordinarily volatile, and showing a declining trend (except in Kuwait) since the early eighties. The performance decline has been especially obvious in Algeria and Lybia. The eighties were a very poor decade for Saudi Arabia, and negative growth rates (less severe and less volatile) were also the rule during the nineties. The Iranian economy stabilised and resumed (slow) growth in the early nineties.

Table B2.1: Average per capita GDP growth rates (%)

	1961-1970	1971-1980	1981-1990	1991-2001
RICH	4.3	2.6	2.0	1.8
EECA-HIGH	6.6	4.4	1.6	0.0
EECA-LOW	5.9	5.2	0.2	-3.3
EA-FAST	4.7	5.6	5.2	4.5
EA-SLOW	3.1	1.6	0.5	2.1
SASIA	1.8	1.1	2.4	3.3
LA-HIGH	2.5	3.0	-0.4	1.8
LA-LOW	1.8	1.3	-1.5	0.4
SSA-HIGH	5.3	6.1	1.5	1.7
SSA-LOW	1.5	0.7	-0.4	0.2
MENA-NO	2.7	4.9	-0.2	1.9
MENA-OIL	9.8	-1.3	-3.2	0.3

Figure B2.1: Rich Countries: GDP per capita growth rate (%)

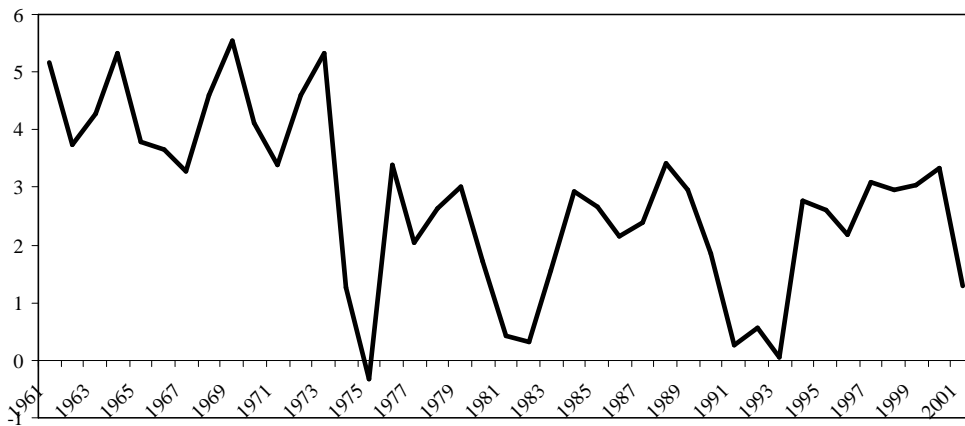


Figure B2.2: Eastern Europe and Central Asia: GDP per capita growth rate (%)

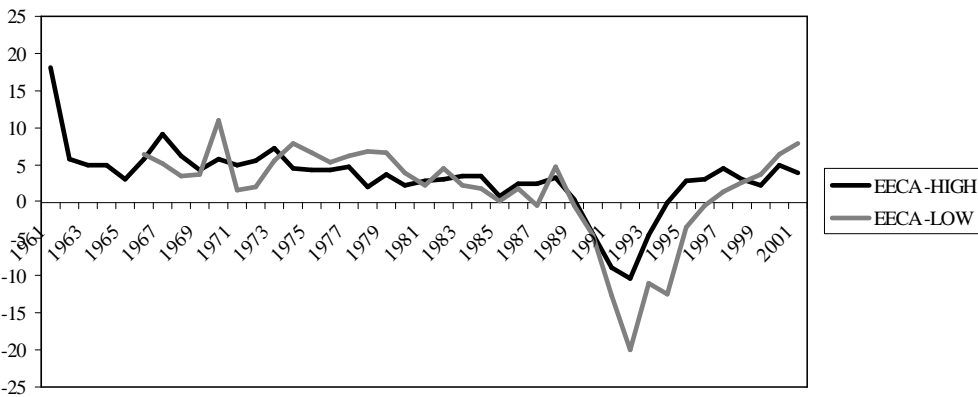


Figure B2.3: East and South Asia: GDP per capita growth rate (%)

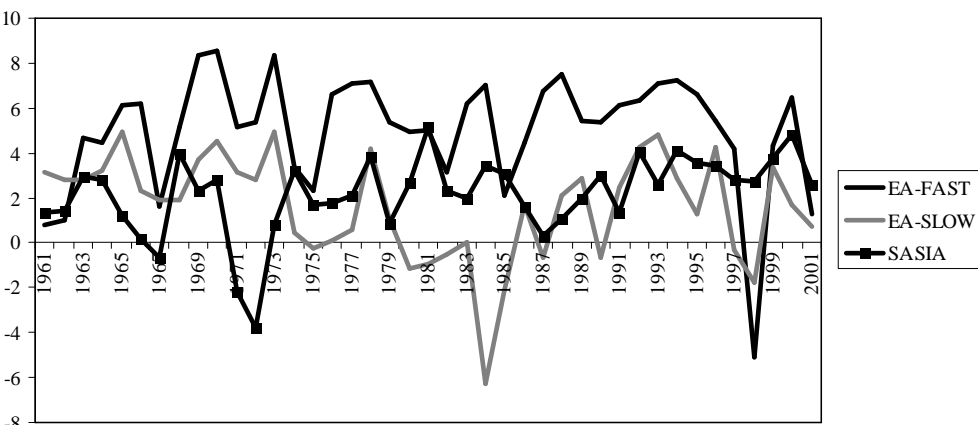


Figure B2.4: Latin America: GDP per capita growth rate (%)

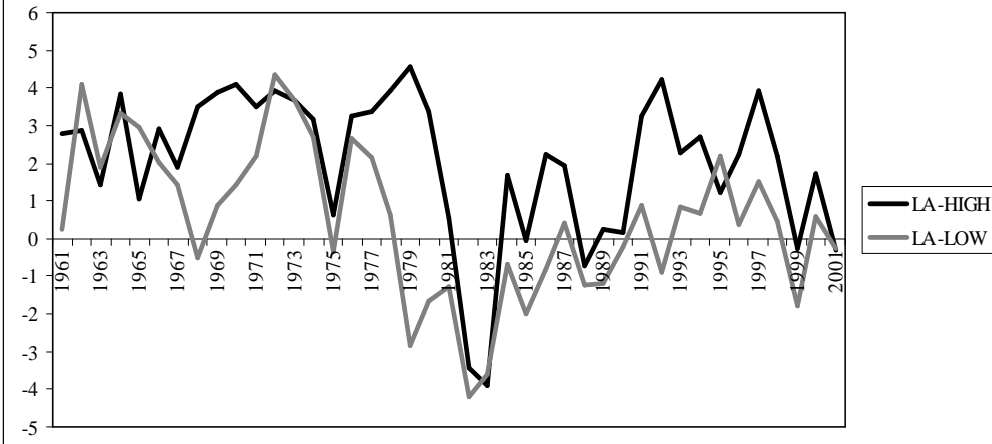


Figure B2.5: Sub-Saharan Africa: GDP per capita growth rate

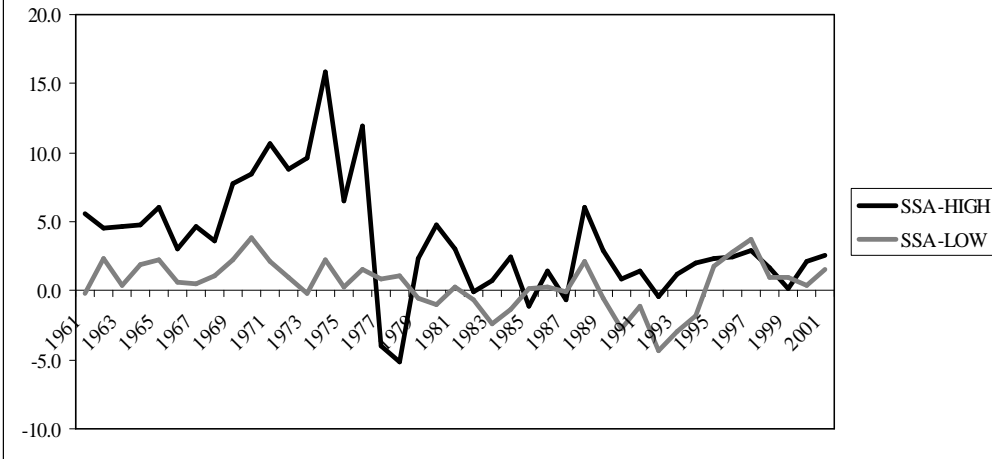
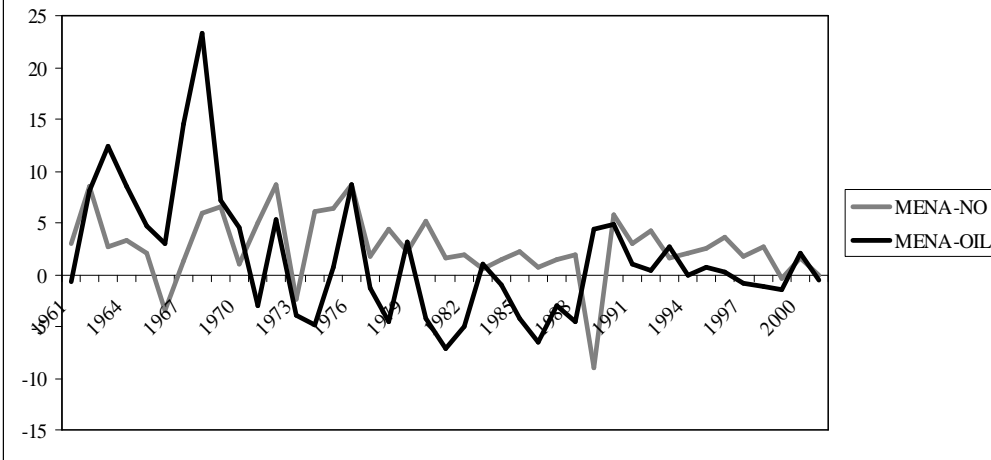


Figure B2.6: Middle East and North Africa: GDP per capita growth rate (%)



Box B3 – Inflation Rates

Table B3.1 and Figures B3.1-B3.6 indicate that inflation has risen and later declined in every single region during the last decades. Each region shows a different pattern:

- **RICH:** Inflation increased rapidly in most countries between the late sixties and the mid-seventies, declined slightly in the late seventies, and then rose again in the early eighties. Later, with the ‘Reagan recession’ and the onset of neoliberalism in most countries, inflation declined steadily (except in Norway, where there was a temporary spike in 2000). There are no indications that inflation will rise significantly in these countries in the near future.
- **EECA-HIGH:** These countries had negligible inflation until the late eighties or the early nineties. Inflation increased rapidly in all countries in the context of their transition to capitalism. In the Czech Republic, Hungary, Poland and Slovakia inflation peaked below 60 per cent and later declined steadily, if not rapidly, towards RICH levels. In Romania and Slovenia the peak was higher, around 200 per cent. In Belarus, Croatia, Estonia, Latvia, Lithuania, Macedonia and Russia inflation followed a similar pattern, but it peaked around 1,000 per cent (or even higher) in the early nineties. Finally, in Bulgaria inflation reached 200 per cent in the early nineties, declined, and then exploded towards 1,000 per cent in 1997, falling rapidly afterwards.
- **EECA-LOW:** The pattern of inflation in these countries was similar to EECA-HIGH, but the peaks were generally higher. In Georgia and the Ukraine inflation reached 15,400 and 3,300 per cent, respectively, in 1993, and in Armenia 4,000 per cent the following year. In all the other countries peak inflation rates exceeded 800 per cent in the early nineties, except in

Albania and Mongolia, where inflation peaked at 250 per cent. In all cases inflation declined steadily in the late nineties.

- **EA-FAST:** Inflation below 10 per cent is the rule, but two countries experienced high inflation, Indonesia (in the mid- and late sixties) and Vietnam (in the late eighties). In Korea inflation hovered between 20 and 35 per cent until the early eighties, but later declined significantly. In the other countries inflation temporarily peaked above 15 per cent; in China this happened in the mid-nineties, in Hong Kong in the early eighties, and in Malaysia, Thailand and Singapore in the mid-seventies.
- **EA-SLOW:** Most countries experienced bouts of high inflation since the mid-eighties, in the same transition context as EECA. In Cambodia inflation reached nearly 150 per cent in the early nineties; in Laos inflation exceeded 120 per cent at the turn of the millennium. In the Philippines inflation exceeded 30 per cent in 1974, and 50 per cent in 1984, but later declined well below 10 per cent. In Papua New Guinea inflation rates have been erratic during the entire period, but inflation seems to have settled below 15 per cent since the mid-eighties.
- **SASIA:** This is a low inflation region. Myanmar experienced exceptionally high inflation rates, above 50 per cent, in 1974, and inflation in this country has tended to exceed 20 per cent since the late eighties. In Bangladesh inflation reached 75 per cent in the mid-seventies, but subsequently declined and it has not exceeded 10 per cent since the late eighties. In the other countries inflation has been volatile, but it only rarely exceeds 20 per cent. It has also declined steadily since the early nineties.
- **LA-HIGH:** This is traditionally a high inflation region. In several countries inflation hovered around 500 per cent for long periods, especially Argentina

(1976, 1984-85 and 1989-90), Brazil (1988-94) and Chile (1973-75). Inflation exceeded 100 per cent in Mexico (in the late eighties), Uruguay (1968, 1973, and 1990-91) and Venezuela (in the late eighties and mid-nineties). In the other countries inflation rates were lower, but still exceeded 50 per cent in the early seventies and/or the late eighties, except in Colombia, Panama and Paraguay. Inflation has declined steadily in all countries, and rarely exceeded 10 per cent anywhere since the late nineties.

- **LA-LOW:** Data available for 1961-2001. The pattern of inflation in these countries resembles LA-HIGH but in some cases it was more extreme, with Bolivia, Nicaragua and Peru experiencing hyperinflation during the eighties. In the other countries inflation rarely exceeded 10 per cent until the first oil shock. Inflation rates subsequently increased everywhere, often reaching 30 per cent. Inflation declined afterwards, but increased again in the late eighties and early nineties, peaking above 60 per cent in Jamaica and Haiti. Elsewhere, inflation has rarely exceeded 30 per cent. Ecuador is an exceptional case, with low inflation generally, and episodes of deflation during most of the eighties and, again, at the end of the century.
- **SSA-HIGH:** These are low inflation countries, except Gabon, where inflation has been exceptionally volatile, alternating between peaks above 50 per cent (in the early seventies) and repeated deflationary episodes. The other countries followed a very similar pattern: inflation tended to increase from below 5 per cent to above 20 per cent in the mid-nineties, and then declined below 10 per cent at the turn of the millenium.
- **SSA-LOW:** These are normally low inflation countries. Congo D.R. experienced hyperinflation in the mid-nineties, and Angola and Liberia a few years later. In the other countries, inflation tended to increase between the late sixties and the early nineties, and then to decline again. In Ghana, Guinea-

Bissau, Mozambique, Sierra Leone, Somalia, Sudan, Uganda, Zambia peak inflation rates exceeded 100 per cent. Most other countries experienced peak inflation rates above 30 per cent. Mauritania is a notable exception, with inflation rarely exceeding 10 per cent. The only country with a continuing inflation problem into the new millenium is Zimbabwe.

- **MENA-NO:** This is a region of low inflation, especially in Morocco and Tunisia. Israel and Lebanon experienced very high inflation in the mid-eighties and early nineties, but this problem was later eliminated; in Turkey inflation continued to be a problem until the end of the decade. In all the other countries inflation declined strongly during the nineties.
- **MENA-OIL:** All countries in this region experienced rapidly accelerating inflation in the aftermath of the first oil shock and, once again, in the early nineties. Algeria and Iran had moderate inflation rates during most of the nineties. Elsewhere, inflation rarely exceeded 20 per cent since the early nineties and, in the UAE, inflation has been nearly non-existent since the early eighties.

Table B3.1: Average inflation, GDP deflator (annual %)

	1961-1970	1971-1980	1981-1990	1991-2001
RICH	4.5	10.4	7.1	2.8
EECA-HIGH	-0.7	1.7	4.3	137.4
EECA-LOW	0.7	1.0	1.0	485.1
EA-FAST	34.7	10.8	21.3	6.9
EA-SLOW	4.7	11.2	21.5	19.4
SASIA	3.9	12.3	10.3	10.3
LA-HIGH	14.2	47.1	134.0	58.6
LA-LOW	3.3	15.0	559.3	62.7
SSA-HIGH	3.1	14.3	11.1	7.5
SSA-LOW	4.8	12.1	20.8	150.8
MENA-NO	3.2	18.7	31.4	16.5
MENA-OIL	2.0	26.2	4.2	9.8

Figure B3.1: Rich Countries: Average Inflation (%)

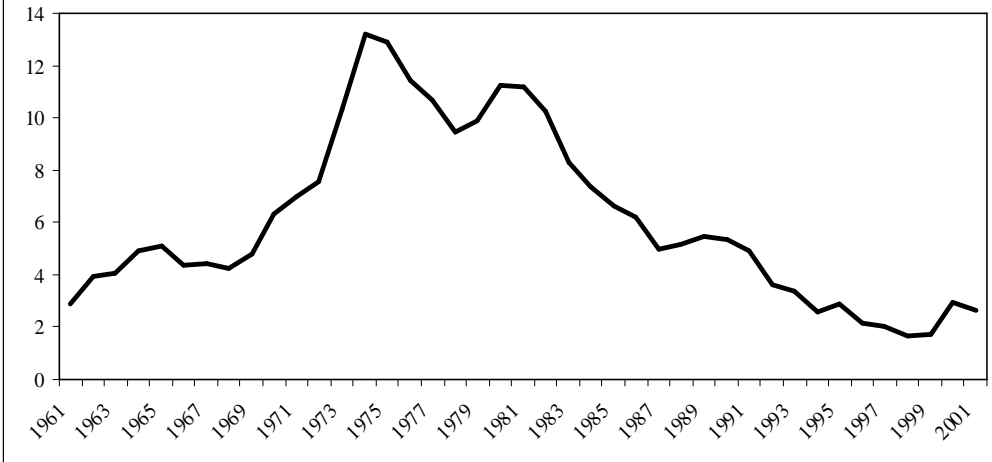
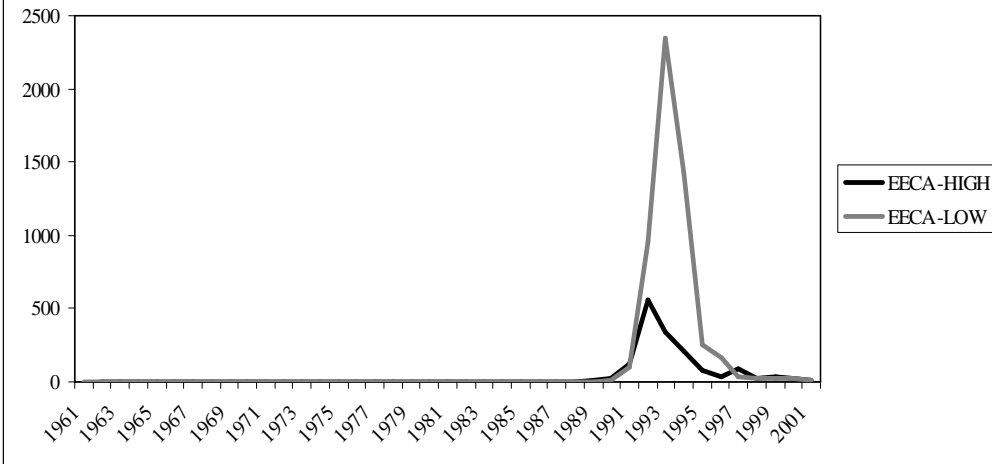


Figure B3.2: Eastern Europe and Central Asia: Average Inflation (%)



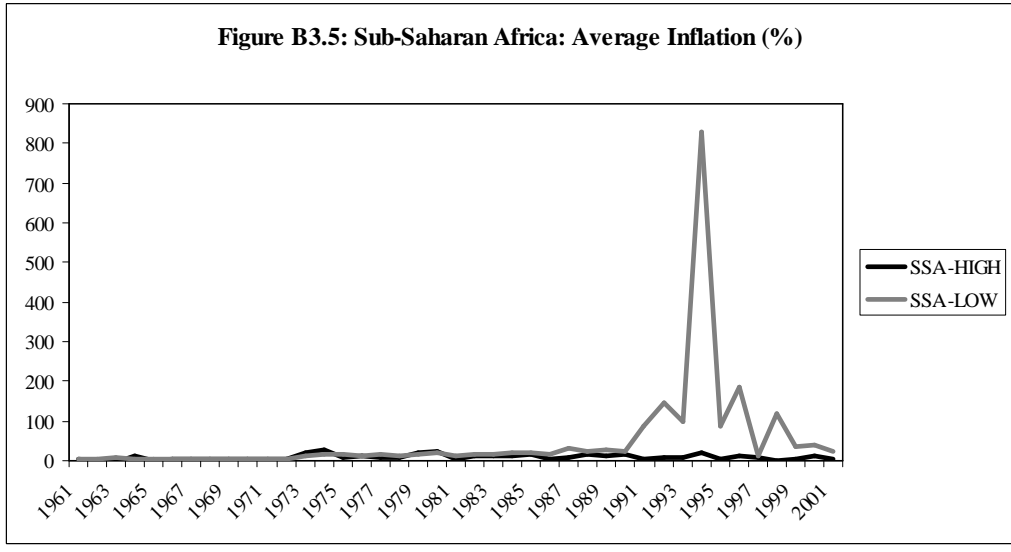
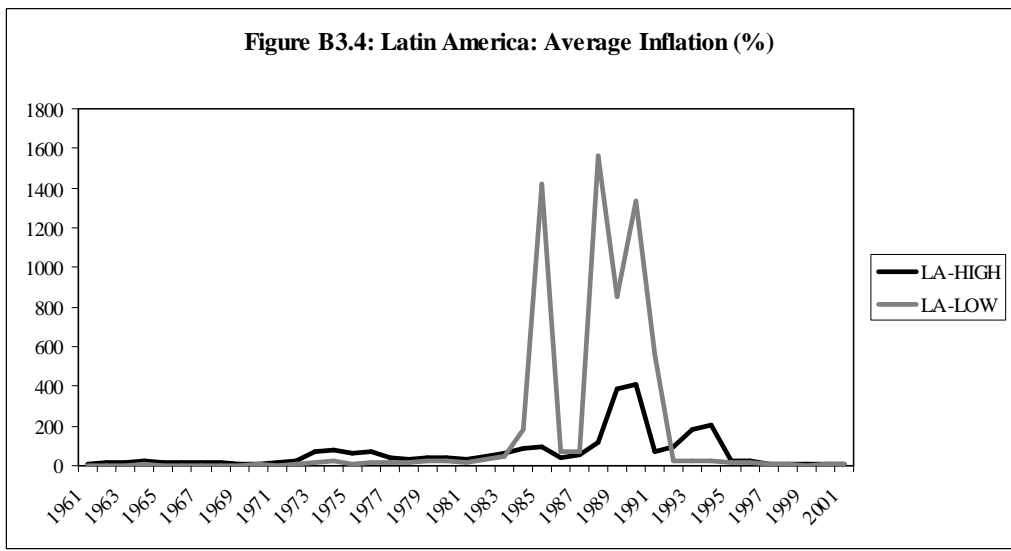
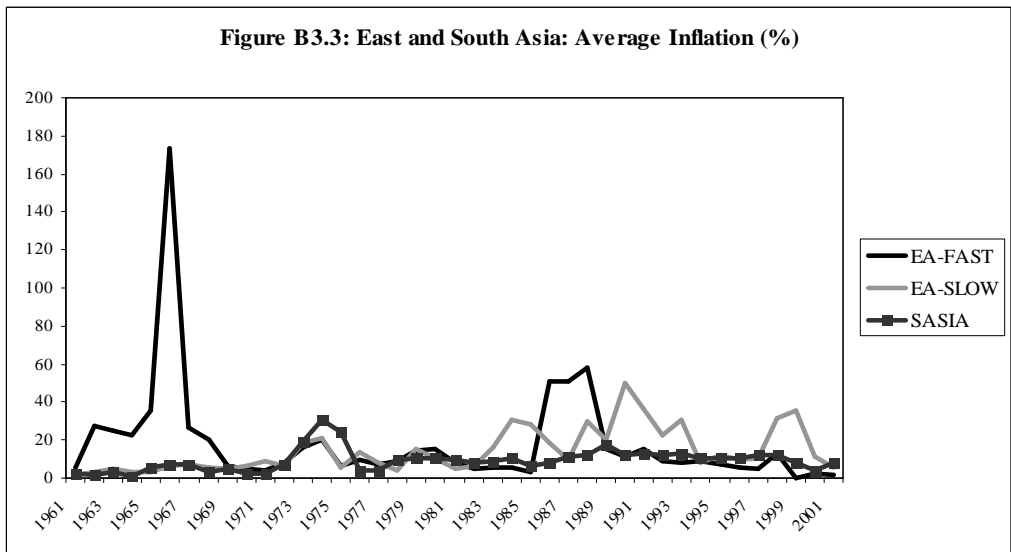
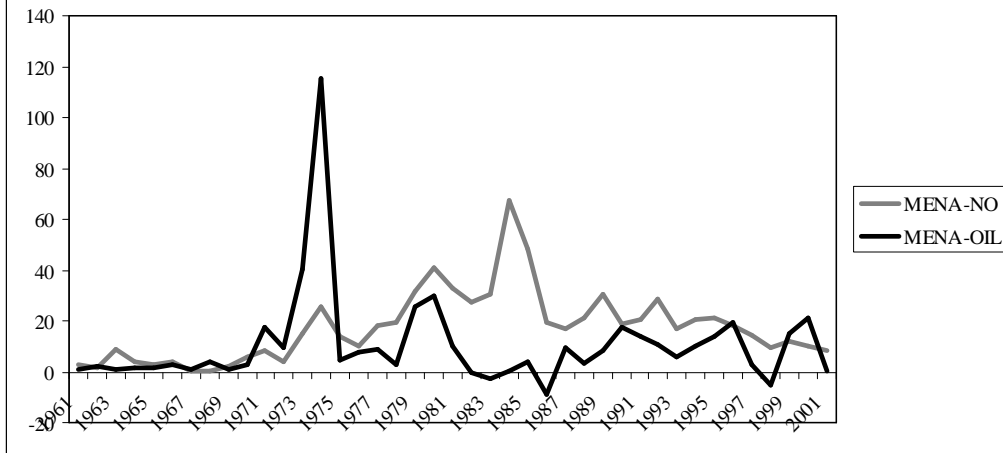


Figure B3.6: Middle East and North Africa: Average Inflation (%)



Box B4 – Inflation, Growth and Unemployment

There seems to be *no* stable relationship between inflation, growth and unemployment. While growth and unemployment are consistently negatively related (for obvious reasons), they seem to move independently of inflation.

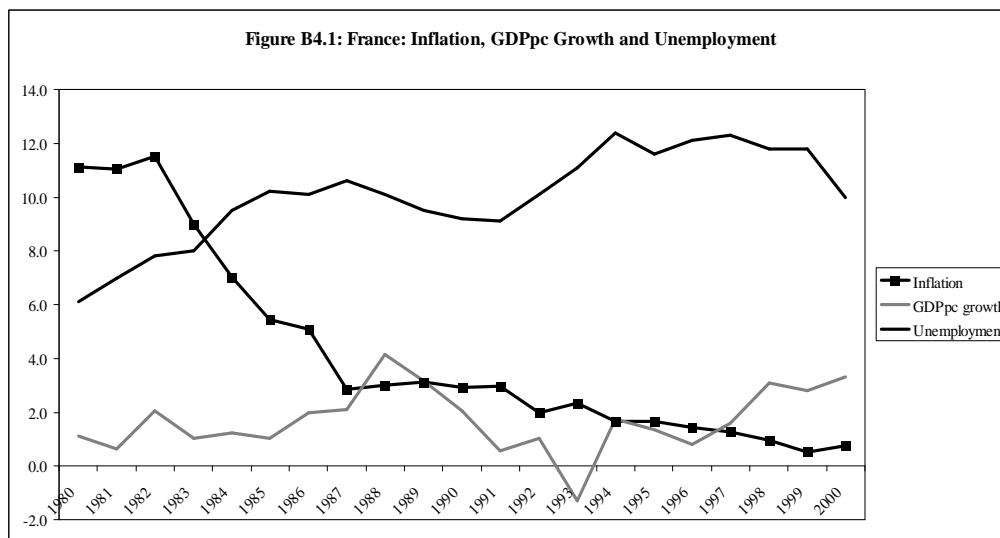
A clear example of this lack of relationship is given by five RICH countries, France, Ireland, Italy, the UK and the US, between 1980 and 2000 (when World Bank data is available) (see Figures B4.1-B4.5).

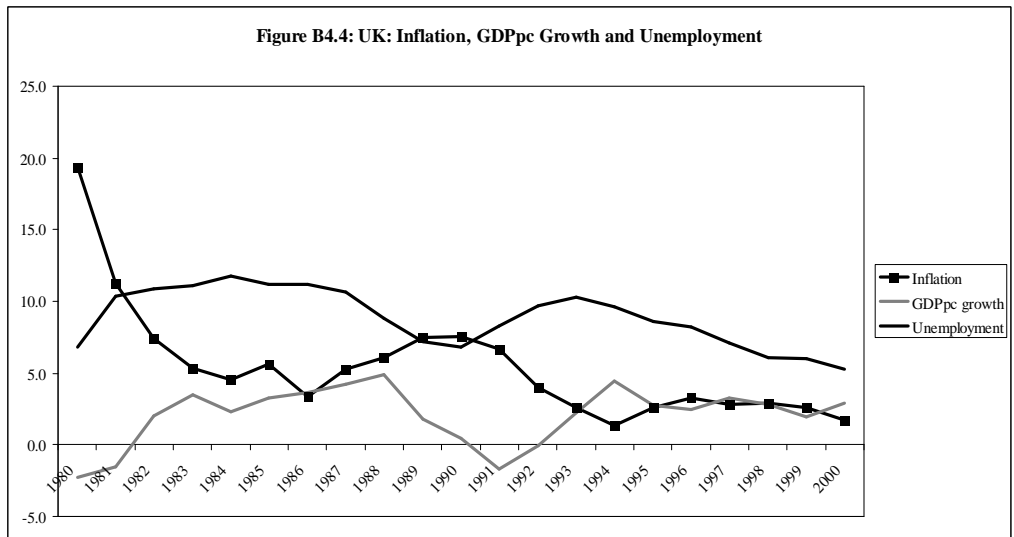
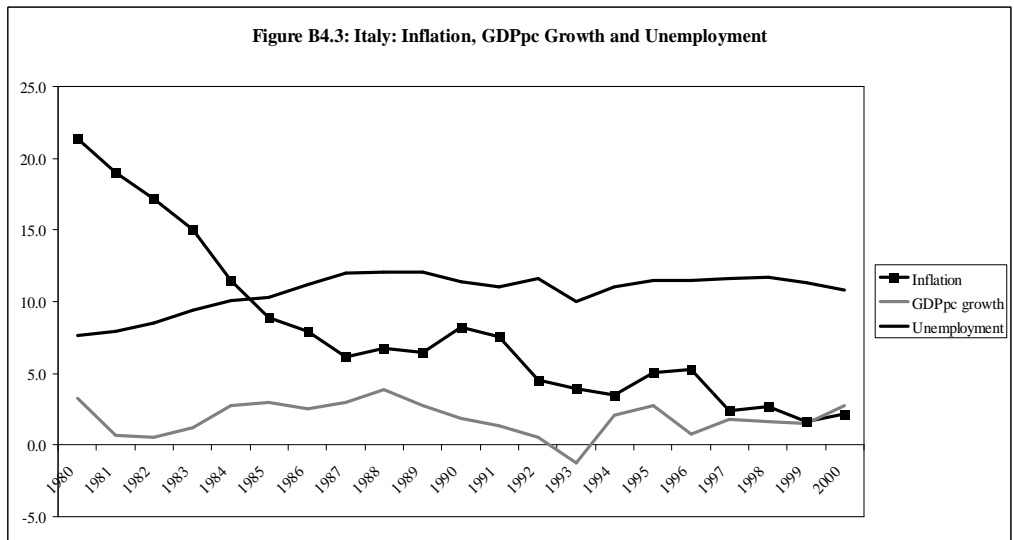
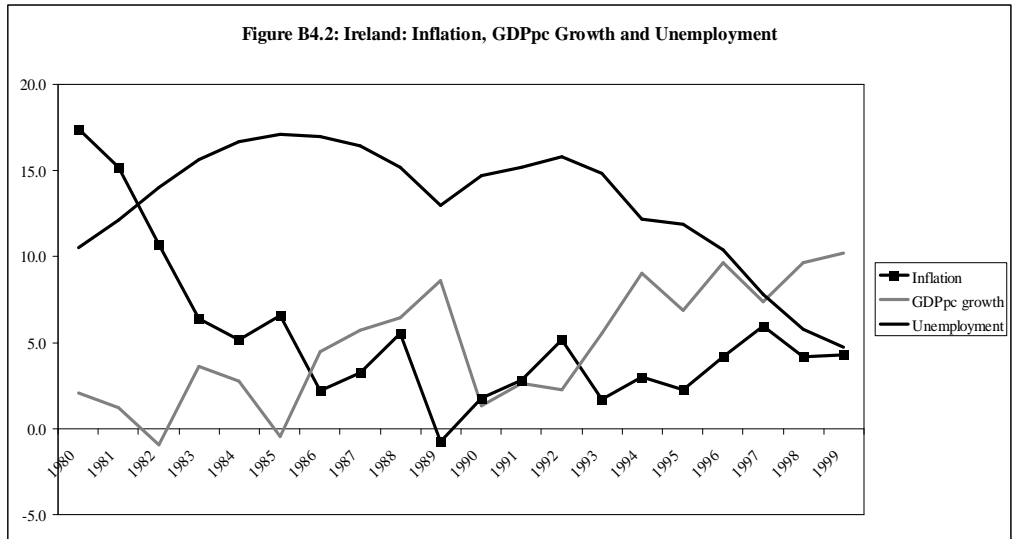
- In France, per capita GDP growth was low during the entire period, especially the early nineties. Unemployment consequently climbed steadily until 1994, and only began to descend later in that decade, as growth picked up again. In contrast, inflation declined steadily during the entire period.
- In Ireland, per capita GDP growth increased regularly during the sample period, starting from a very low base and reaching extraordinarily high 10 per cent annual rates towards the end of the period. Unemployment, that started from a relatively high base, peaked at 17.1 per cent in the mid-eighties, but it began to decline steadily in the early nineties, and reached 4.7 per cent in 2000. Inflation fell until 1989, then increased slightly but only touched above 5 per cent in 1998.
- In Italy, GDP growth was stable but low, and unemployment was also stable but high during the entire period. In contrast, inflation declined almost every year.
- In the UK, economic growth was strong and stable during the eighties and since the mid-nineties, but unemployment responded only slightly. In contrast,

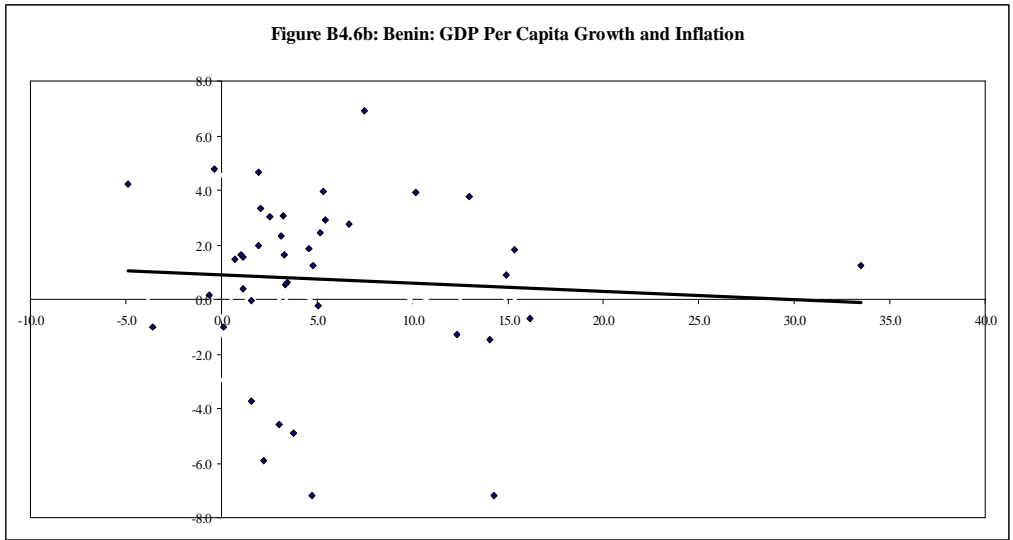
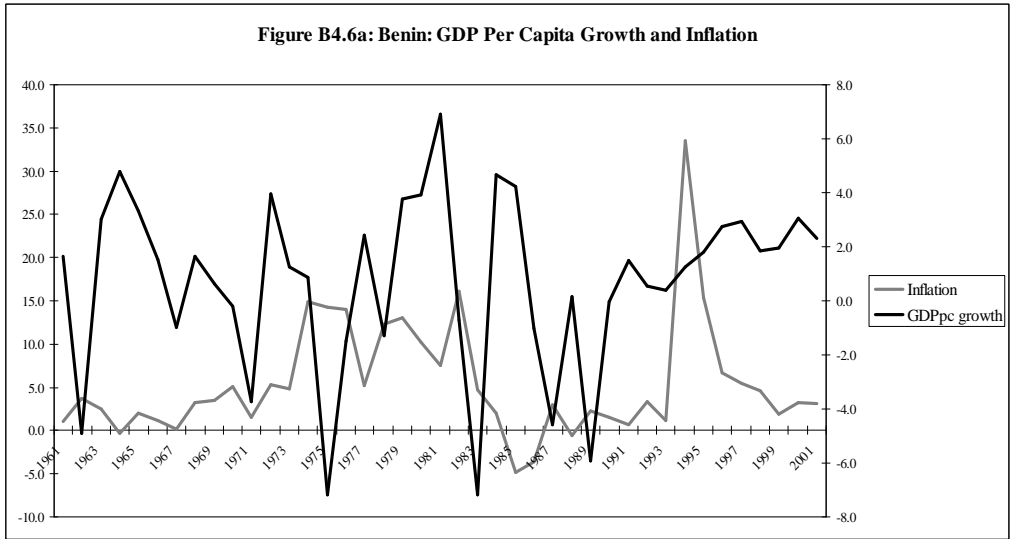
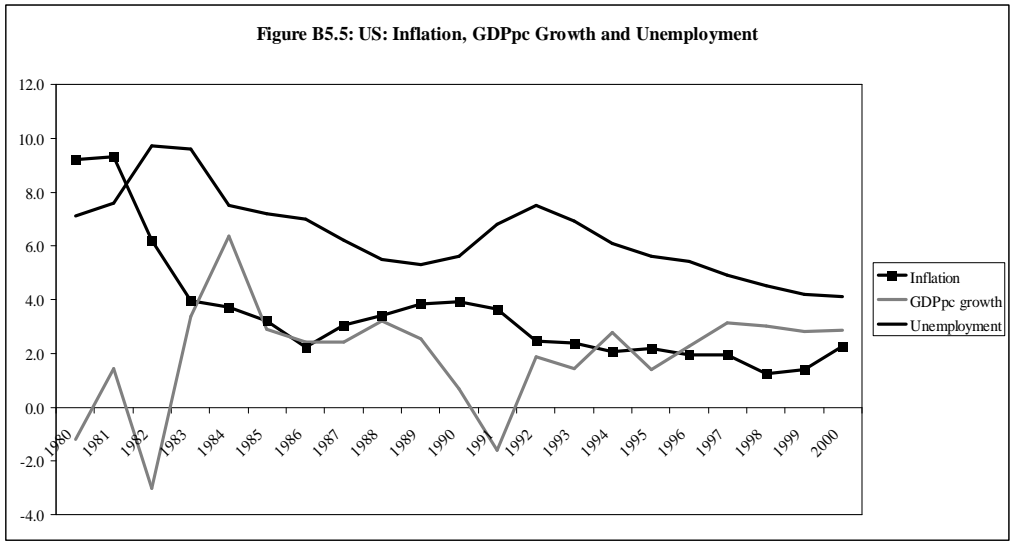
inflation tumbled (in spite of a recrudescence in the early nineties). It has been maintained well below 5 per cent since 1992.

- Economic growth in the US was stronger than in the UK, although it showed a similar pattern. Unemployment reacted more strongly, and declined steadily especially since the early nineties. In contrast, inflation fell in the early eighties and has been under control ever since.

Several developing countries had similar experiences (unemployment was not considered because data is less reliable than in the developed countries). There is *no* significant relationship between inflation and growth in low growth countries such as Benin, Cameroon, Central African Republic and Chad, or in middle-income countries such as Colombia, South Korea and Thailand (see Figures B4.6-B4.12).







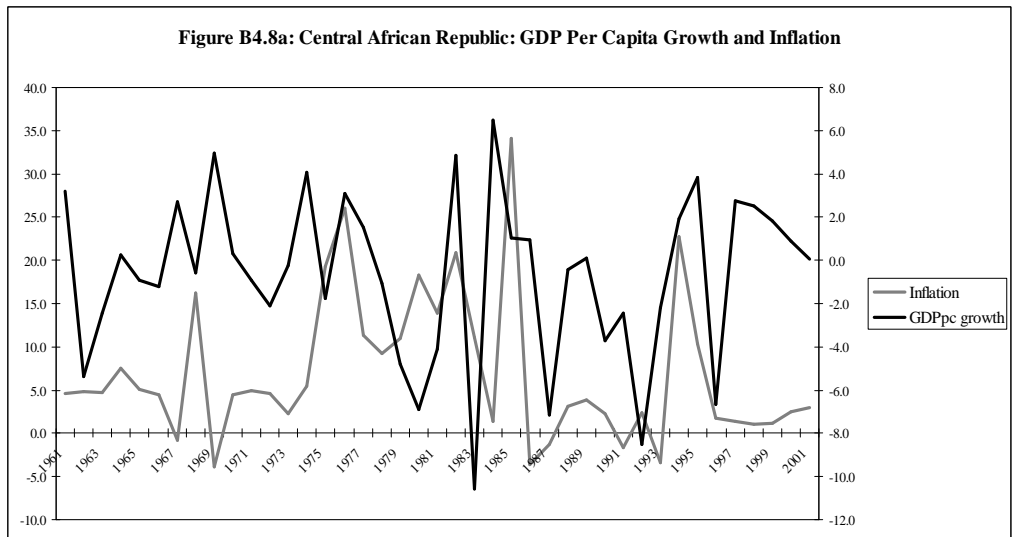
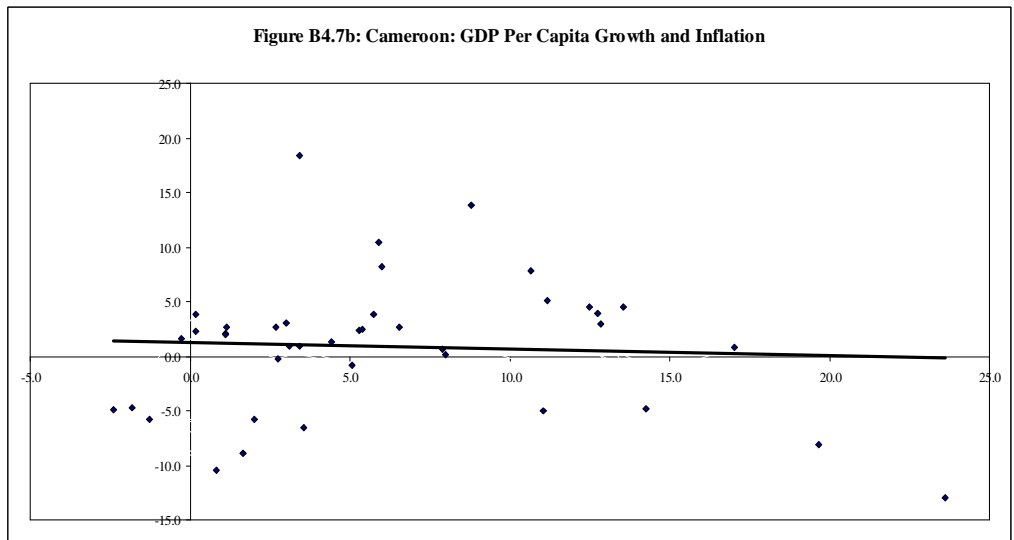
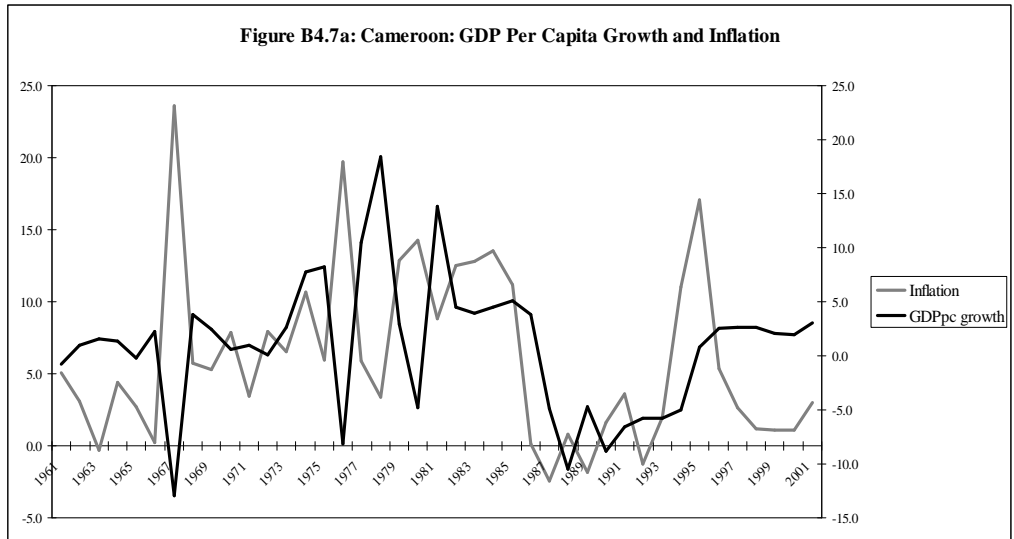


Figure B4.8b: Central African Republic: GDP Per Capita Growth and Inflation

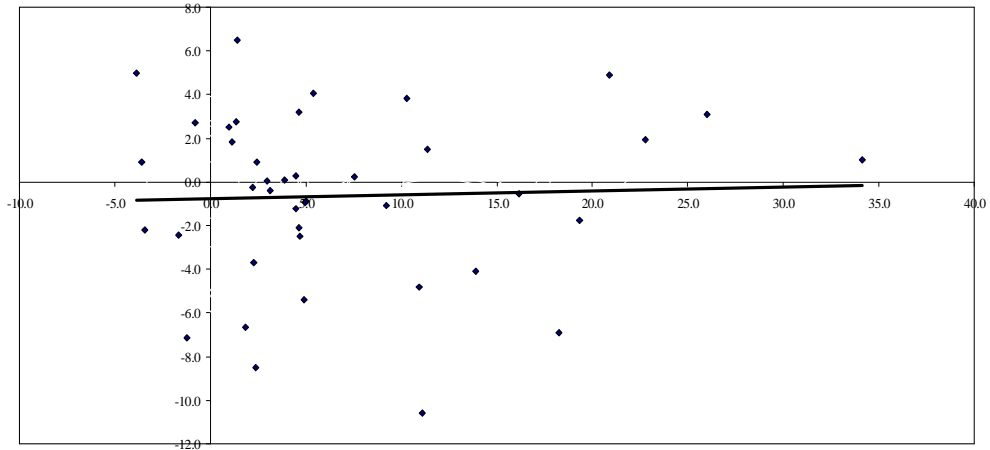


Figure B4.9a: Chad: GDP Per Capita Growth and Inflation

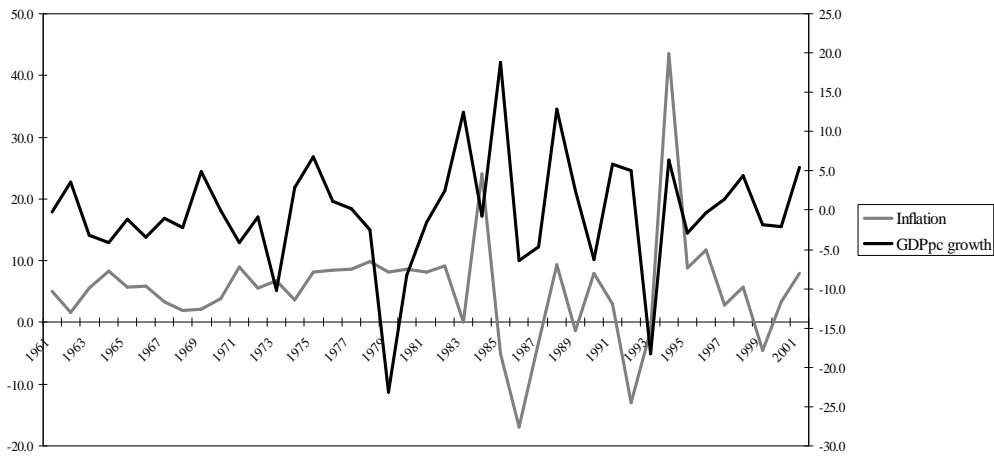
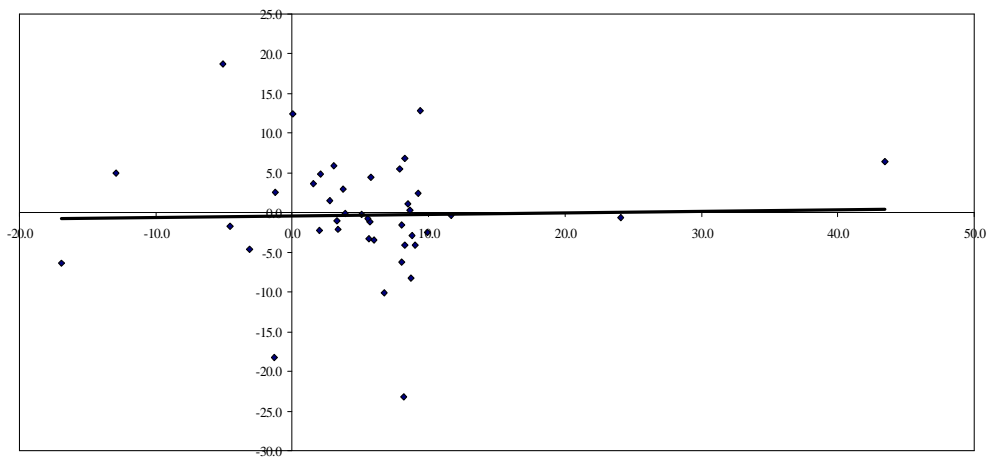
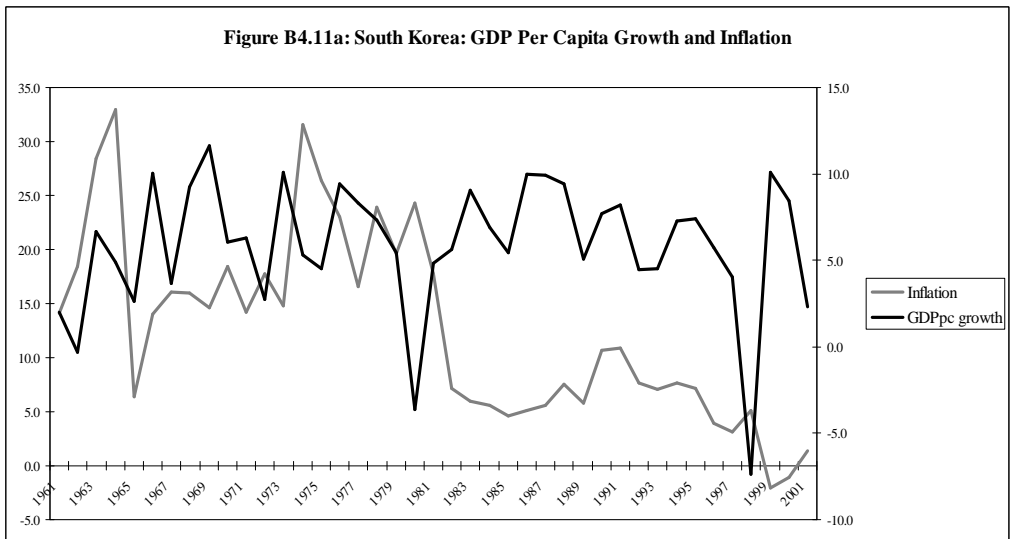
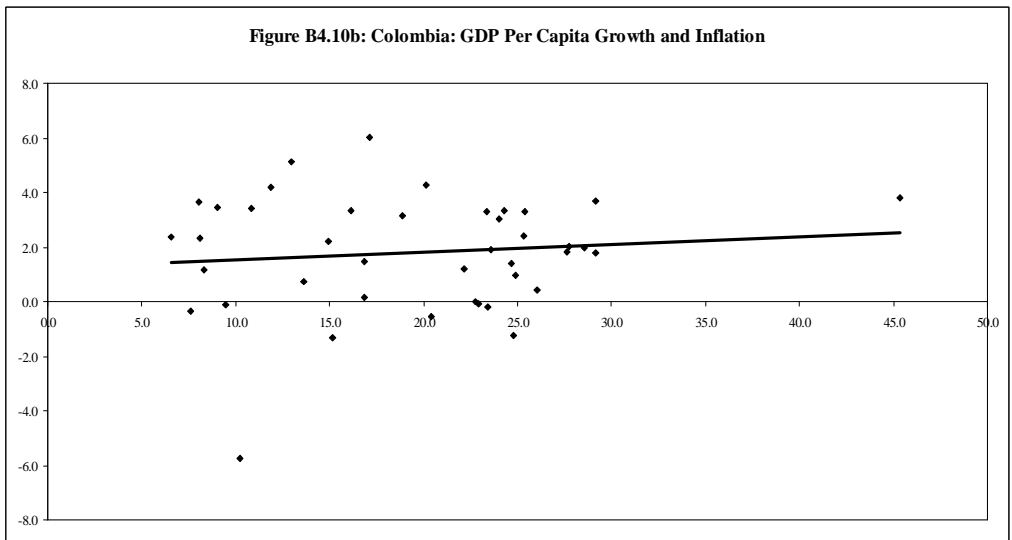
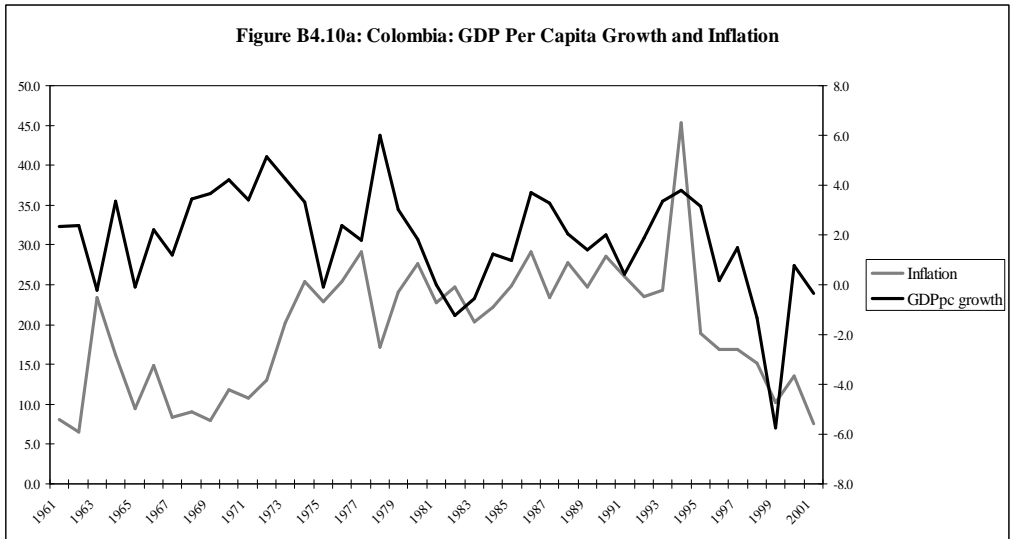
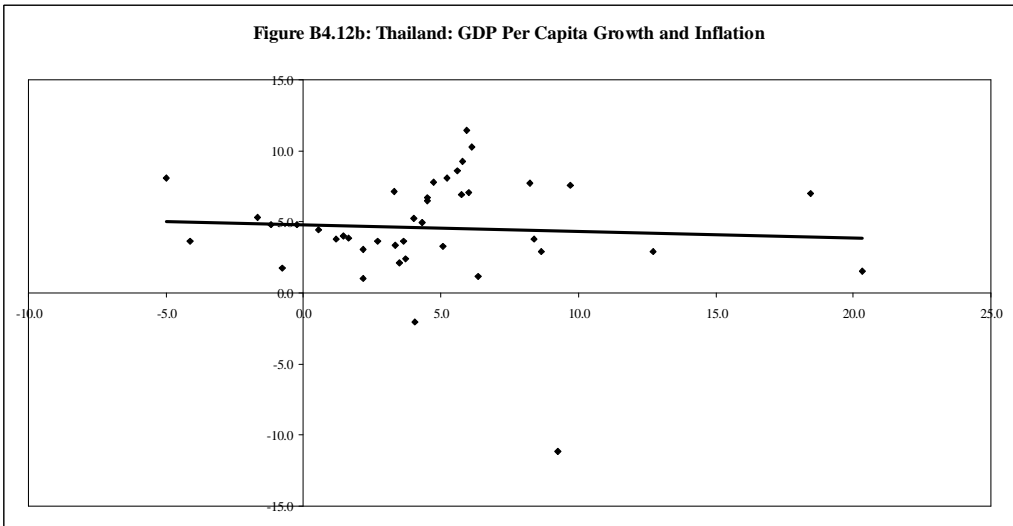
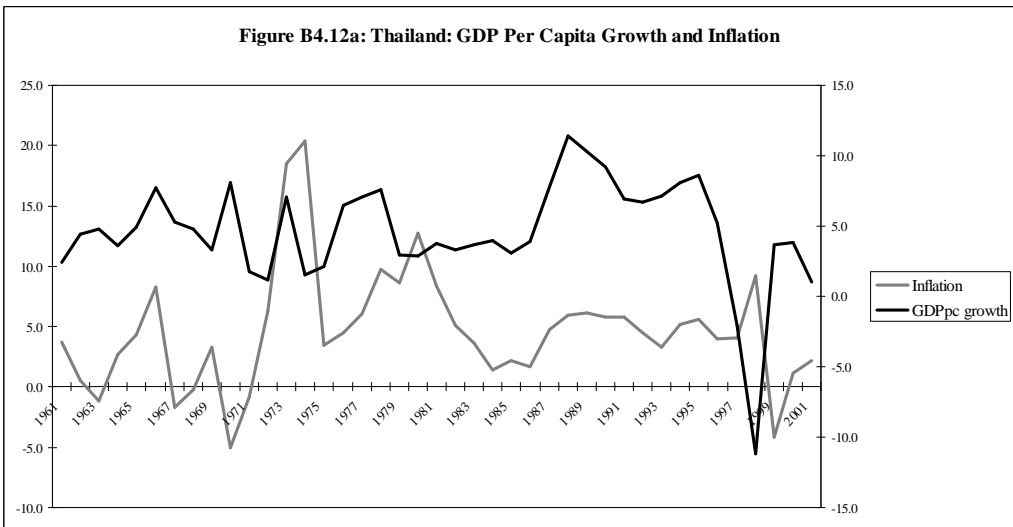
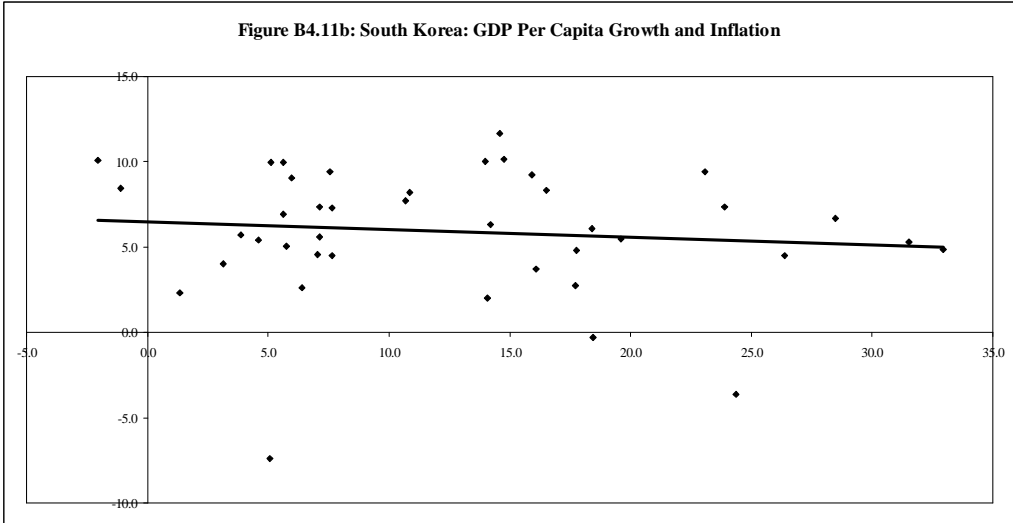


Figure B4.9b: Chad: GDP Per Capita Growth and Inflation







Box B5 – Real Interest Rates and Distribution

Data on real interest rates (RIR) and Gini coefficients is available for 112 countries. A straightforward relationship between their average RIR and their latest available Gini coefficient shows a clear positive relationship (see Figure B5.1).

This relationship seems to be robust. If the sample is divided between high RIR (above 10 per cent per annum),¹ medium RIR (5-9.9 per cent per annum),² low RIR (0-4.9 per cent per annum)³ and negative RIR countries⁴ a similar relationship holds (see Figures B5.2-B5.5).

Conversely, the relationship also seems to hold (except in one case) if countries are divided between high inequality (latest Gini above 45),⁵ medium inequality (Gini between 35 and 44.9)⁶ and low inequality countries (Gini below 34.9)⁷ (see Figures B5.6-B5.8).

¹ Armenia, Azerbaijan, Brazil, Cambodia, Cameroon, Chile, Colombia, Croatia, Ecuador, Gambia, Georgia, Israel, Kyrgyzstan, Macedonia, Madagascar, Moldova, Mongolia, Mozambique, Namibia, Nicaragua, Paraguay, Peru, Russia and Uruguay.

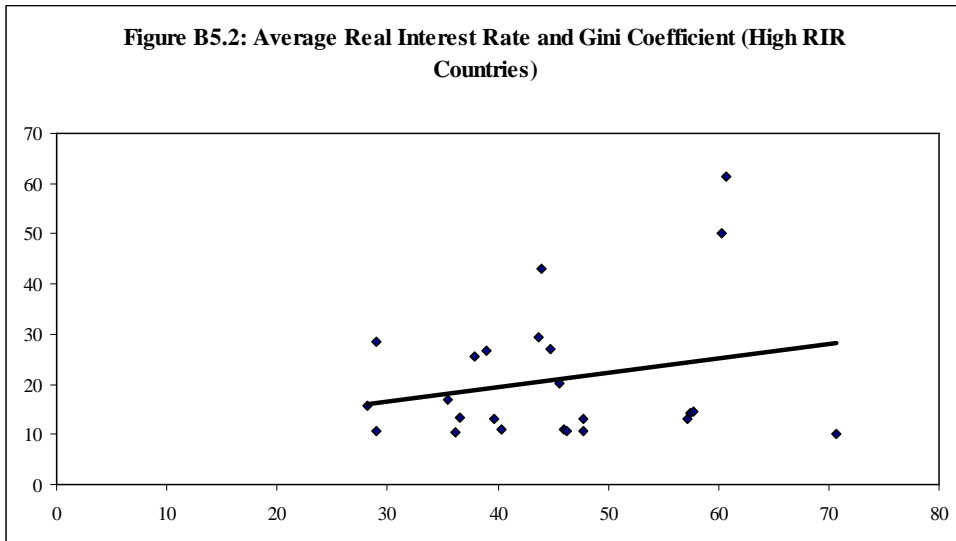
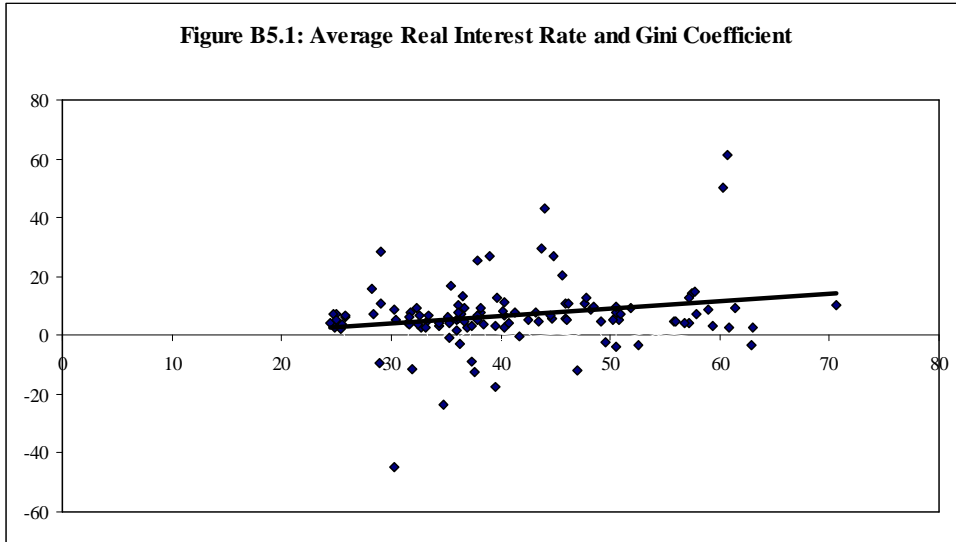
² Australia, Austria, Bangladesh, Belgium, Bolivia, Burkina Faso, Central African Republic, Costa Rica, Cote d'Ivoire, Denmark, El Salvador, Germany, Guinea, Honduras, India, Indonesia, Italy, Jamaica, Jordan, Kenya, Latvia, Malawi, Mali, Mexico, Netherlands, New Zealand, Niger, Norway, Panama, Papua New Guinea, Philippines, Poland, Rwanda, Senegal, Singapore, Slovakia, Slovenia, Sweden, Tanzania, Thailand, Trinidad and Tobago, Vietnam and Yemen.

³ Botswana, Burundi, Canada, China, Czech Republic, Egypt, Ethiopia, Finland, France, Greece, Guatemala, Hong Kong, Hungary, Japan, Korea, Laos, Lesotho, Malaysia, Mauritania, Morocco, Nepal, Portugal, South Africa, Spain, Sri Lanka, Swaziland, Switzerland, United Kingdom, United States and Zimbabwe.

⁴ Algeria, Belarus, Bulgaria, Estonia, Ghana, Guinea-Bissau, Lithuania, Nigeria, Sierra Leone, Tajikistan, Tunisia, Uganda, Ukraine, Venezuela and Zambia.

⁵ Botswana, Brazil, Burkina Faso, Cameroon, Central African Republic, Chile, Colombia, Costa Rica, El Salvador, Ethiopia, Gambia, Guatemala, Guinea-Bissau, Honduras, Lesotho, Madagascar, Malawi, Malaysia, Mali, Mexico, Namibia, Nicaragua, Niger, Nigeria, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Russia, Rwanda, Sierra Leone, South Africa, Swaziland, Venezuela, Zambia and Zimbabwe.

⁶ Algeria, Armenia, Australia, Azerbaijan, Bolivia, Cambodia, China, Cote d'Ivoire, Ecuador, Estonia, Georgia, Germany, Ghana, Greece, Guinea, Hong Kong, India, Israel, Italy, Jamaica, Jordan, Kenya, Laos, Lithuania, Mauritania, Moldova, Mongolia, Morocco, Mozambique, Nepal,



New Zealand, Portugal, Senegal, Singapore, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Uganda, United Kingdom, United States, Uruguay and Vietnam.

⁷ Austria, Bangladesh, Belarus, Belgium, Bulgaria, Burundi, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Hungary, Indonesia, Japan, Korea, Kyrgyzstan, Latvia, Macedonia, Netherlands, Norway, Poland, Slovakia, Slovenia, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Ukraine and Yemen.

Figure B5.3: Average Real Interest Rate and Gini Coefficient (Medium RIR Countries)

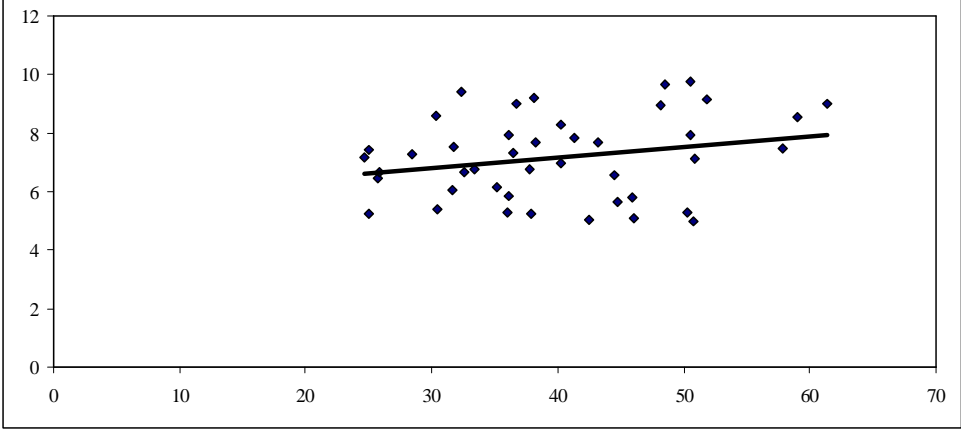


Figure B5.4: Average Real Interest Rate and Gini Coefficient (Low RIR Countries)

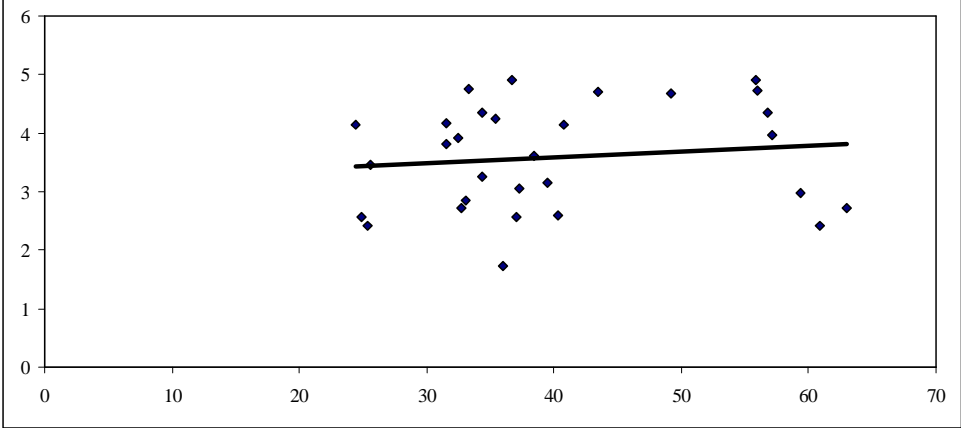


Figure B5.5: Average Real Interest Rate and Gini Coefficient (Negative RIR Countries)

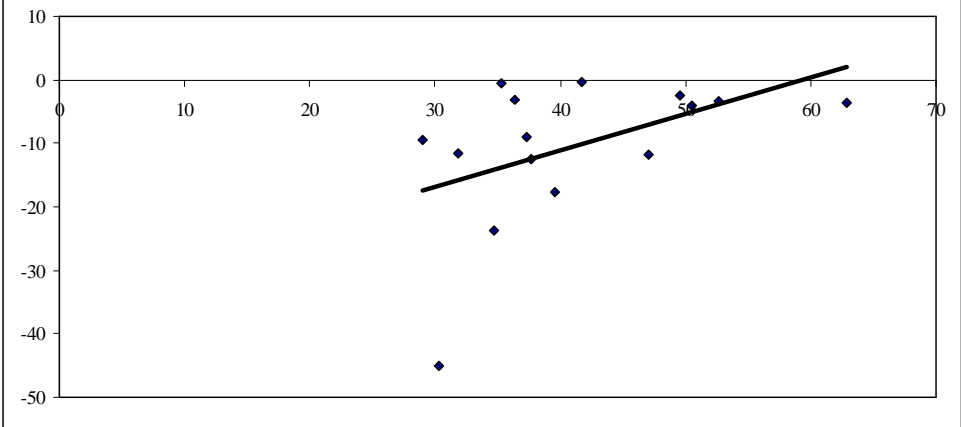


Figure B5.6: Average Real Interest Rate and Gini Coefficient (High Inequality Countries)

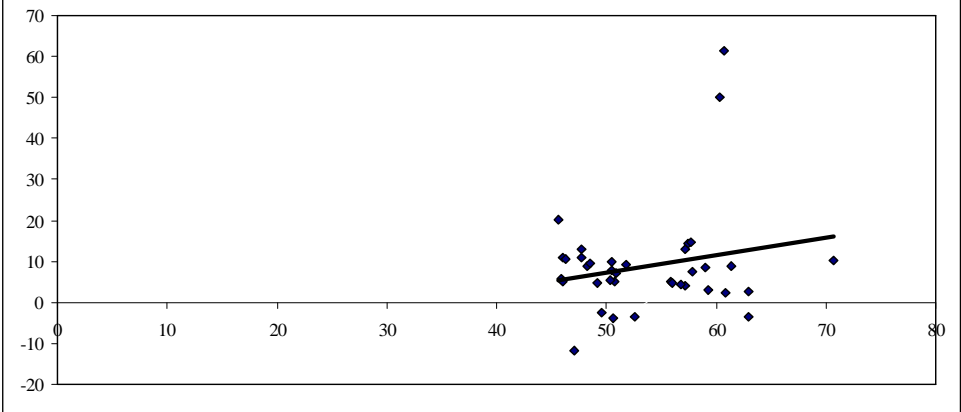


Figure B5.7: Average Real Interest Rate and Gini Coefficient (Medium Inequality Countries)

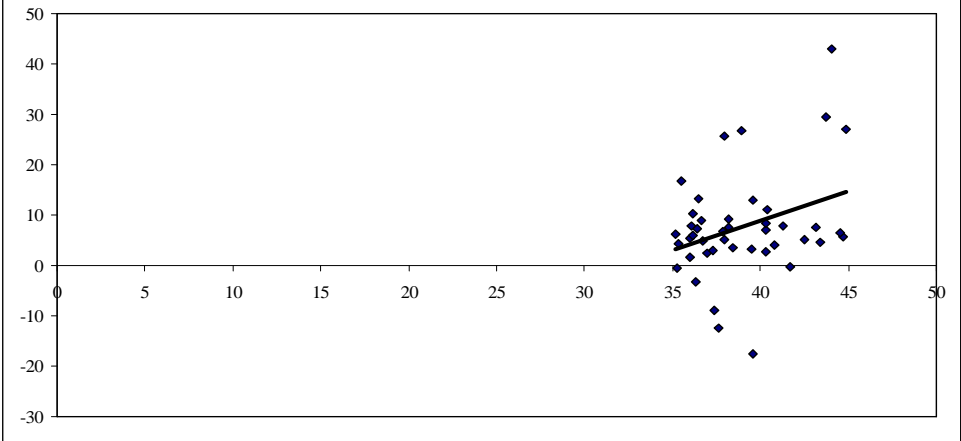
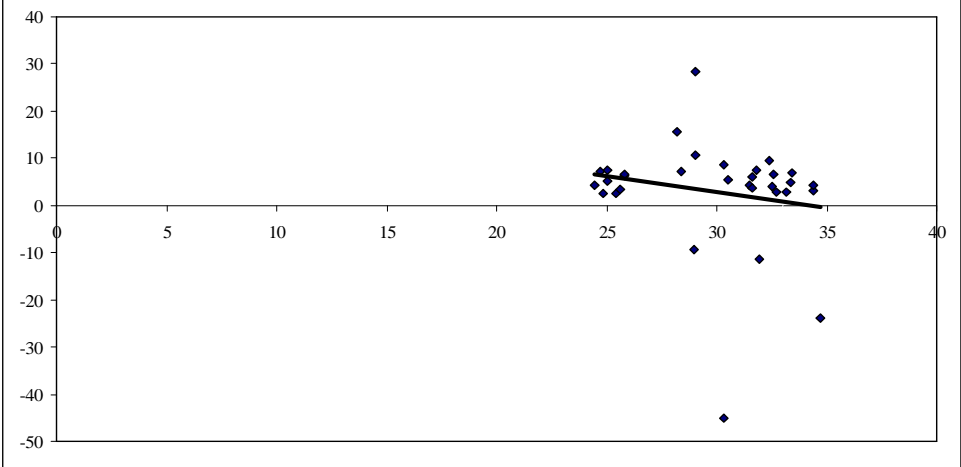


Figure B5.8: Average Real Interest Rate and Gini Coefficient (Low Inequality Countries)



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