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John Weeks

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Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.umass.edu/peri/



The Freetown Declaration: Countercyclical Policy for Africa

John Weeks
Professor Emeritus
School of Oriental and African Studies
University of London

Abstract:

In August 2009 the African finance ministers issued the Freetown Declaration, in which they committed their governments to “implement fiscal stimulus measures” to counter the effects of the international financial crisis on their economies. This paper analyzes the feasibility of realizing this commitment. It considers the availability of policy instruments in the sub-Saharan countries for countercyclical intervention. On the basis of this, the paper proposes a fiscal stimulus tailored to the conditions and constraints of the countries of the region. In a majority of the countries the fiscal expansion could be financed domestically, in other countries governments would require additional external funding, and only for a few countries would a stimulus not be appropriate. [JEL: E3, E62, O11, O55]

The Freetown Declaration: Countercyclical Policy for Africa¹

1. Introduction

In August 2009 the Caucus of African Governors of the IMF, World Bank and African Development Bank (also known as the Caucus of African Finance Ministers) met in Freetown, Sierra Leone.² Responding to crisis in the international economy, the meeting unanimously issued the Freetown Declaration, in which they collectively committed themselves to implement a fiscal stimulus and called for the international agencies to support it.³

This paper considers the feasibility of a fiscal stimulus for the sub-Saharan countries, most of which are low-income and exporters of primary products. Section 2 reviews the policy recommendations in the Freetown Declaration relevant to a fiscal stimulus. Section 3 presents the algebra of a stimulus and uses this to demonstrate the effect of loan and grant conditionalities on policy options. Section 4 considers in detail the policy instruments available to sub-Saharan governments to implement effectively a stimulus program. The final section indicates how donors and lenders could support countercyclical fiscal policy by the governments of the region.

2. Recovery Program in the Freetown Declaration

In late April 2009 at the spring meeting of the development committee of the IMF and the World Bank, the president of the African Development Bank warned that the sub-Saharan countries would be severely affected by the global financial crisis that had begun the previous year.⁴ When the African finance ministers met in Freetown in mid-August his warning had been realized. In this context the ministers

¹ This paper benefited from comments by Joseph Stiglitz of Columbia University when an earlier version was presented at the meeting of the African Taskforce in Pretoria in July 2009, and from Samura Kamara, Minister of Finance of Sierra Leone. It based on the author's keynote address to the Caucus of African Governors of the IMF, World Bank, African Development Bank, Sierra Leone, 12-13 August 2009.

² This is an annual meeting of finance ministers to discuss the issues which would arise at the subsequent IMF-World Bank meeting, which in October 2009 was held in Istanbul.

³ The declaration was adopted on 12 August 2009, by the Caucus of African Governors of the IMF, World Bank and African Development Bank. Henceforth cited as (CAG 2009). Found at http://www.mofed.gov.sl/index2.php?option=com_content&do_pdf=1&id=99.

⁴ The warning included the prediction that, "It will certainly take African countries a longer time to emerge from the crisis than other countries." <http://www.afdb.org/en/news-events/article/world-bank-imf-spring-meetings-africa-needs-a-rapid-response-to-crisis-says-afdb-president-4520/>

and their representatives issued a declaration unusual for its clarity, forcefulness and break with prevailing policy.

Unlike previous declarations that had pledged the governments to orthodox policies of macro stability and institutional reform,⁵ after noting the need for sound policy and social ‘safety nets’, the Freetown Declaration issued a bold declaration,

We, the African Governors to the BWIs and AfDB, commit to...
Implement fiscal stimulus measures where appropriate to weather the impact of the global economic downturn;
Expand high-growth yielding public investments...to restore and raise our countries growth and employment potential as well as crowd-in private investment;
Implement monetary policies that support the short-term fiscal stimulus measures...
Remain prepared to exit from the countercyclical fiscal stimulus policies as soon as the macroeconomic conditions permit. (CAG 2009)

These commitments, if implemented, would represent a break with the standard IMF macroeconomic framework that stresses minimizing fiscal deficits and a tight monetary stance to achieve low inflation, usually single digit. The commitment to a fiscal stimulus would imply a lower fiscal surplus for a few countries and for most it would mean a larger deficit. More fundamentally, the commitment to a stimulus implies using the deficit as part of an active fiscal policy rather than as a problem to be reduced.

The commitment to increase public investment has three policy implications that are potentially inconsistent with orthodox macro policy. First, it asserts the public sector as an active driver of growth rather than merely establishing the framework for private sector driven growth. Second, the IMF and World Bank view that public borrowing ‘crowds out’ private investment is explicitly reversed: the Declaration asserts that public investment, which would by necessity be financed through borrowing, can ‘crowd-in’ private investment.⁶ Third, it provides an implicit strategy for an active fiscal policy: countercyclical intervention will be used to

⁵ For example, the declaration of October 2007 referred to “wide array of far-reaching reforms to achieve macroeconomic stability”. The full text of the statement is found at: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21520315~pagePK:34370~piPK:34424~theSitePK:4607,00.html>

⁶ A case for public investment as a driver of poverty reducing growth is found in Roy and Weeks (2004). The orthodox view that public investment crowds out private is stated without nuance at <http://blogs.worldbank.org/african/a-fiscal-stimulus-for-africa>.

stabilize output near potential, and public investment will foster higher growth rates through increased productive capacity.

A further break with Washington Consensus macro policy is made by the commitment to use monetary policy to support the active fiscal policy. While policy consistency requires that fiscal and monetary measures be coordinated, an accommodating monetary policy contradicts one of the basic tenets of most IMF programs, inflation targeting, as well as associated limits on money growth.⁷ Even more fundamental, committing monetary policy to support fiscal policy renders it derivative from fiscal policy, a return to so-called Keynesian macro management. Finally, the commitments explicitly emphasize the fiscal stimulus as countercyclical and short term by specifying the need to exit from it as economies recover.

After stating the recovery program, the Freetown Declaration presents a list of ‘requests’ for the multilateral development agencies of which they are governors,

To this end [the fiscal stimulus], African IMF/WBG Governors urge the International Monetary Fund to

- Support our policy frameworks [and give] us the needed policy space...to leverage [external] resources...
- Facilitate expeditious access to the newly created financing instruments;
- Mobilize additional resources to allow an increase in concessional lending while ascertaining that these new instruments are fully funded;
- Promptly activate the precautionary component of the SCF [Special Credit Facility].

We ask the World Bank Group to introduce more flexible and adaptable budget support instrument that is capable of responding quickly to crisis.

The second, third and fourth requests of the IMF are derivative from the first, allowing governments the flexibility, ‘policy space’, to design and implement their programs. The request of the IMF for “expeditious access” and of the World Bank for “more flexible and adaptable budget support” reflects a general view among the officials at the Caucus of tardiness by the Fund and the Bank in their response to the impact of the global crisis on African countries.

The Freetown Declaration represented a clear break from the macro policy framework common to most African countries prior to the international financial crisis of 2008. This macroeconomics of this framework combined with a cautious monetary stance and a neutral fiscal policy, in the context of market deregulation. This policy approach, based on a “price constrained framework”, has as its

⁷ This is demonstrated analytically in Section 3.

prerequisite that the world economy operates near its potential.⁸ From mid-2008 it was clear that aggregate demand was insufficient to permit the world economy to achieve its potential. In response governments of the major industrial countries introduced “stimulus packages” designed to replace the fall in private demand with public expenditure.

In this demand constrained world economy, African governments have two general policy options. They could pursue a “business-as-usual, hope-for-the-best” option in which they continue with the policy framework designed for a robust world economy and await international recovery. This would follow advice to place primary emphasis in macro policy on “stability”, which in IMF terminology means preventing inflation, reaching targets for fiscal deficits, and maintaining a free-floating exchange rate.⁹ It does not mean stabilizing output by policy intervention.

However, the crisis may have brought a degree of change in IMF policy advice. A January 2009 IMF report on the world economy called for a “firm commitment” to a “timely implementation of fiscal stimulus across a broad range of advanced and emerging economies”. In line with this commitment, a May 2009 press release reported that the IMF recommended a fiscal stimulus for a low income country, Mozambique.¹⁰ In its survey of the impact of the financial crisis, the

⁸ An early use of this terminology is in Liejonhufvud (1968, Section 2). The theoretical and policy difference between “price constrained” and “quantity constrained” economies is discussed in Weeks (1989). The recently revised edition of that book can be found at <http://jweeks.org>.

⁹ A clear statement of this approach is found in an IMF report on the global financial crisis, Countries should focus on macroeconomic stability. In some countries with falling inflation there may be scope for monetary easing; others, however, still experience continued or renewed price pressures. Those with flexible exchange rates should allow them to move, so that they function as shock absorbers. (IMF 2009a, viii)

¹⁰ The complete IMF statement on fiscal policy reads as follows, In current circumstances, the timely implementation of fiscal stimulus across a broad range of advanced and emerging economies must provide a key support to world growth. Given that the current projections are predicated on strong and coordinated policy actions, any delays will likely worsen growth prospects. Countries that have policy room should make a firm commitment to do more if the situation deteriorates further. Fiscal stimulus packages should rely primarily on temporary measures and be formulated within medium-term fiscal frameworks that ensure that the envisaged build up in fiscal deficits can be reversed as economies recover and that fiscal sustainability can be attained in the face of demographic pressure. (IMF 2009c, 1)

A press release titled “IMF Mission Calls for Fiscal Stimulus in Mozambique” states, “In the short term, given Mozambique’s low level of public debt, the [IMF] mission sees scope to at least partly offset the impact of the global economic crisis on Mozambique with somewhat more expansionary fiscal and monetary policies.” (IMF 2009d). The IMF approved higher deficit limits for El Salvador and Ethiopia (Bretton Woods Project 2009, 9)

World Bank also recommended that governments “assess their ability to undertake countercyclical policies”.¹¹ The African Development Bank as well recommended countercyclical fiscal intervention.¹² Without explicitly mentioning countercyclical measures, in 2009 the IMF recommended for Sierra Leone that the country’s fiscal deficit be allowed to increase to respond to the impact of the financial crisis on import prices.¹³ None the less, a commitment to the pre-crisis orthodoxy remains among professionals in the Bretton Woods institutions.¹⁴

3. Countercyclical Fiscal Policy: Analytical framework

3.1 Countercyclical Algebra

For success a countercyclical policy package must be consistent with a sustainable balance of payments and manageable inflation. Achieving the appropriate balance requires careful use of available policy instruments. As shown in the next section, in most sub-Saharan countries monetary policy is not effective except to accommodate fiscal policy. This reduces the stimulus tools to policy and exchange rate management. With underutilized resources both measures should stimulate output. This section considers the algebra of a stimulus package for countries in which both instruments can be used. The next section considers a strictly fiscal stimulus for countries locked into fixed exchange rate arrangements.

Both devaluation and fiscal expansion have potentially negative effects that require careful management. Since the income elasticity of taxes is typically less than unity in sub-Saharan countries, increasing government expenditure will always increase the fiscal deficit relatively to national income. Simultaneously there would

¹¹ “The challenge for policymakers in this environment is to assess their ability to undertake countercyclical policies given the resources available to them as well as their institutional and administrative capacity to rapidly expand and adapt existing programs.” (WB 2009, 10)

¹² The African Development Bank’s 2009 report calls on donors and lenders to “[Focus] on results, rather than prescribing rigid policies and actions, allowing countries space to respond according to their particular needs and circumstances”. More specific, it recommends that donors and governments “[i]ncrease flexibility in macroeconomic frameworks to allow more scope to balance macroeconomic stability and the need to stimulate domestic demand”. (ADB 2009, 2)

¹³ “[IMF] Staff is proposing that the primary fiscal deficit be revised upward by 0.4 percentage points of GDP to accommodate the unanticipated budget impact of the rise in world oil prices.” (IMF 2009b, 5).

¹⁴ In his personal blog in early 2010 the World Bank chief economist for Africa, Shanta Devarajan, argued against a fiscal stimulus “for Africa” on the grounds that increasing a fiscal deficit would result in inflation or a reduction in private investment (“crowding out”) or both. <http://blogs.worldbank.org/africacan/a-fiscal-stimulus-for-africa>.

be an increased and possibility unsustainable trade deficit. The policy goal is to prevent the latter through devaluation, which has its own problem, the inflation it generates.

Identifying the appropriate balance between increased expenditure and devaluation is facilitated by use of algebra. The rate of growth of the real demand for output (y) for a time period can be specified as the weighted sum of the growth of autonomous expenditures times the multiplier:

$$y = \beta[a_1i + a_2g + a_3x - a_4z], \quad \sum a_i = 1$$

The lower case letters i , g , x and z are the rates of change of expenditures that are exogenous with respect to national income, including the exchange-rate-induced components of trade (private investment, government expenditure, exports, and imports, respectively). The a_i terms are the shares in national income of each variable and β is the multiplier. Exports have an autonomous component whose rate of change is x^0 , and a component determined by the real exchange rate. Imports are a function of national income and the real exchange rate. Define ϵ_x and ϵ_z as the elasticities of exports and imports with respect to the real exchange rate, p as the price level and δ the marginal propensity to import:

$$x = x^0 + \epsilon_x e^*$$

$$z = \delta y - \epsilon_z e^*$$

The change in the real exchange rate (e^*) is the change in the nominal rate (e) minus the rate of inflation (p). The *ceteris paribus* rate of inflation is the pass-through rate of a devaluation (the marginal propensity to import, δ).

$$e^* = e - p = e - \delta e = (1 - \delta)e$$

$$x = x^0 + \epsilon_x(1 - \delta)e$$

$$z = \delta y - \epsilon_z(1 - \delta)e$$

These can be substituted into the growth of demand equation. We interpret x^0 as an external shock to export demand, and assume that it causes depressed expectations that render the growth of private investment zero. Assume that the government seeks to prevent national income from falling ($y = 0$). To simplify, write a_3/a_2 as α and define $(\epsilon_x + \epsilon_y) = \epsilon_T$. If the trade elasticities are positive, ($\epsilon_T > 0$), a

real devaluation improves the trade balance (Marshall-Lerner condition).¹⁵ For zero growth, the real demand equation is:

$$0 = a_2g + a_3x^0 + a_3\varepsilon_T(1 - \delta)e$$

For any shock to exports (x^0) the relationship between the change in expenditure and the devaluation is determined by three parameters, the ratio of exports to government expenditure, the real exchange rate elasticity of trade, and the propensity to import. If the exchange rate is constant, the government expenditure that stabilizes output is:

$$g = \alpha x^0$$

For no increase in government expenditure, stabilizing output requires the nominal devaluation to be:

$$e = x^0/[\varepsilon_T(1 - \delta)]$$

The relationship between e and g for zero growth is shown in the upper right quadrant of Figure 1. The upper left quadrant relates the nominal exchange rate to its inflationary effect (e and p), and the lower left quadrant links the change in the real exchange rate to the trade deficit (e^* and $X-Z$).¹⁶ An export shock decreases national income and increases the trade deficit. We assume that the government must return to the initial trade deficit within one time period or suffer an unsustainable loss of reserves. Regaining the initial trade deficit requires a real devaluation of e^*_1 , which implies a nominal devaluation of e_1 . This sets the lower limit of the devaluation, which defines a feasible range for the increase of government expenditure to prevent a fall in output ($g > g_1$).

Two other goals of the government constrain policy, inflation and deficit limits. In Figure 1 in the upper right quadrant there is a feasible policy range, below the ‘inflation limit’ and above the “deficit limit”. If the acceptable inflation rate is below p_1 , then no combination of devaluation and increased expenditure is consistent with restoring the trade balance and stabilizing output in the short run, though it would be possible with a series of devaluations in the medium term. This demonstrates the necessity for exchange rate management. Leaving the currency to

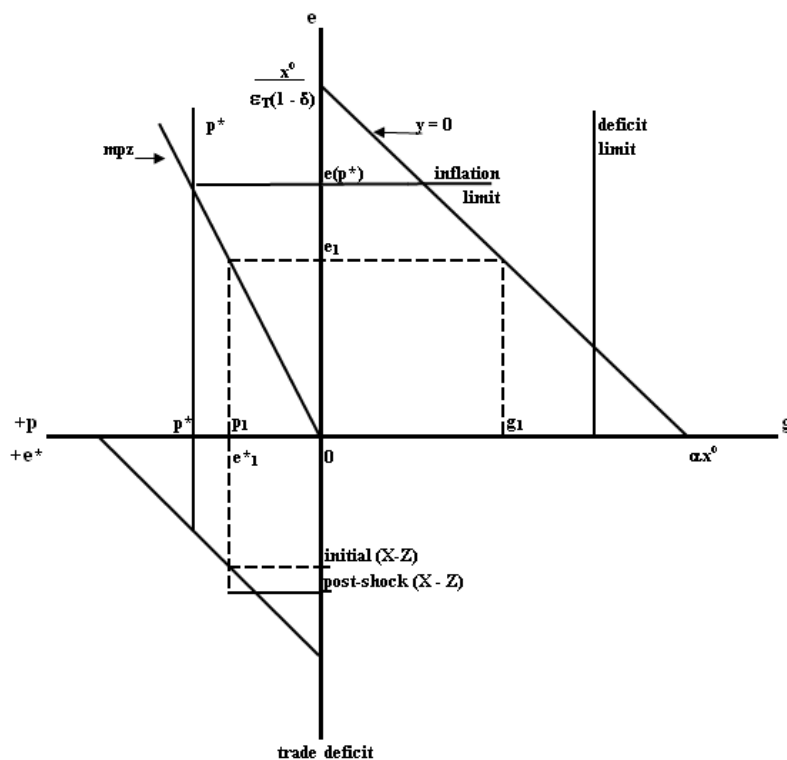
¹⁵ The more familiar condition of greater than unity refers to the nominal exchange rate and export and import values.

¹⁶ Figure 1 is a simplified presentation. It does not include the effect of changes in national income on import demand.

float when expenditure increases can result in excessive inflation as the depreciation seeks balance of trade sustainability. If the limit for the fiscal deficit were below what would be generated by expenditure increase g_1 , there might remain a feasible short term region involving a low expenditure increase and a large devaluation.

If at the initial conditions the fiscal deficit is close to that set by donor and lender conditionality and/or the inflation rate is near its conditionality limit, the government has no space for a policy response to the export shock. It is this policy constrained situation that the Freetown Declaration sought to avoid by requesting more policy space from the IMF and other donors and lenders.

Figure 1: Policy Options for countercyclical intervention



3.2 Countercyclical Deficit Finance

Countercyclical policy increases demand when the economy grows below its long run potential, and decreases it when output encounters resource scarcities that provoke inflationary pressure. This output stabilization policy maintains an economy as close to its potential as is consistent with other goals of policymakers. It is not a growth policy, which would involve public investment to contribute to increasing productive capacity.

To be relevant for the low income countries of sub-Saharan Africa, countercyclical intervention requires concrete specification. Reducing taxes would be relatively ineffective because of the nature of the revenue generation. In low income countries personal income taxes are rarely important, with most revenue from taxes on internal commerce, international trade and corporations.¹⁷ Almost all the company tax is collected from foreign enterprises engaged in extractive activities, and reducing their taxes would have little impact on their domestic investment decisions.

The alternative to tax reduction, enhancing demand by public expenditure, requires that the increases are flexible enough to be initiated quickly when there is a demand shock, and terminated with similar dispatch as the economy approaches its potential. Public investments do not meet this condition because of their relatively long and inflexible construction time. Much of current expenditure is also inflexible. For example, it might be possible to increase the number of school teachers if trained people were available, but it might not be rational to terminate them when the economy approaches its potential. If it were judged rational from an educational point of view, it might prove politically difficult.

Because of the inappropriateness of capital expenditure and much of current expenditure of countercyclical intervention, government could base stimulus programs in the sub-Saharan countries on temporary employment schemes, 'cash for work'. Appropriate projects would be rapidly-completed activities using employment intensive techniques that have a large component of repair and maintenance.¹⁸ Examples of such programs are digging sanitation ditches, repair of public buildings, environmental improvement through erosion reduction, and clearing of rural footpaths. These activities were implemented in 2009 throughout Sierra Leone by the National Commission for Social Action as part of a countercyclical policy (Weeks 2009d). The projects would make a contribution to community welfare, though their

¹⁷ The World Bank data base *World Development Indicators* gives disaggregated tax statistics for twenty sub-Saharan countries in the 2000s. For all but two trade taxes were at least twenty percent of revenue. The exceptions were South Africa and the Republic of Congo. Sales taxes accounted for thirty percent or more for eleven of the twenty countries. Personal and company taxes brought in twenty percent or more of revenue in only four of the countries (Ghana, Kenya, South Africa and Zambia). The source provides no information for the major petroleum exporters, Angola, Cameroon, Chad, Equatorial Guinea, Gabon and Sudan. <http://ddp-ext.worldbank.org/ext/DDPQQ/>

¹⁸ The International Labor Organization calls such projects as "labor-intensive public works". The ILO website provides further information on short term employment programs. <http://www.ilo.org/public/english/employment/recon/eiip/index.htm>

primary purpose is to increase aggregate demand through the expenditures of those directly and indirectly employed. To be effective, the employment schemes would have the following characteristics:

- 1) identified and “stock-piled” prior to the need for them, with accounting procedures in place to reduce the likelihood of misuse of funds;
- 2) easily initiated and quickly terminated, implying that they should be implemented by the central government in order to avoid delays due to limited administrative capacity of local governments; and
- 3) wages and salaries are the major element of expenditure, with a low capital component.

Some issues that plague public works projects with controversy need not be relevant for ones whose purpose is countercyclical. For example, the wage at which workers are paid is a secondary consideration because these are not long term or even medium term employment schemes. The appropriate wage will vary across countries and regions, guided by the principle that the primary purpose of the projects is to increase demand quickly. This would be best achieved by hiring as many people as possible, which implies paying wages at or below prevailing rates. These programs would be introduced when the labor is in excess supply, thus unlikely to affect prevailing wage rates. A ministry of finance study in Sierra Leone recommended this type of employment program as a policy measure to counter the effects of the financial crisis (MoFED-EPRU 2009).¹⁹

Clear rules should be established for the initiation and termination of countercyclical projects. A “countercyclical” expenditure that becomes permanent negates its purpose. Initiation and termination could be triggered by a policy rule based on appropriate macroeconomic indicators. The specific indicator will vary by country, determined by the development and structure of the economy. Among sub-Saharan countries, only in South Africa are employment statistics sufficiently current and reliable to serve as a trigger indicator. In other countries, almost all of which lack

¹⁹ In Sierra Leone the most important cash for work project in 2009 was supported by US\$ 4 million from the World Bank. It employed about 14,000 people in infrastructure maintenance.

quarterly data on aggregate output, a proxy based on trade statistics could be constructed.²⁰

As shown in the next section, external support in addition to current aid levels would be required to support a stimulus in some countries. Its unfortunate but the case that donor funding does not lend itself to countercyclical programs because of the fixed, but often unreliable, schedule of allocation and disbursement.²¹ To make their funding more appropriate for countercyclical programs, donors should accelerate disbursement and adjust their allocation procedures to allow for an “aid fund” analogous to national mechanisms created for resource booms. Money could be drawn from such a fund when the economy is below potential, and “hoarded” when near full potential. Donor grants ear-marked for investment could not be used for countercyclical expenditures, for reasons explained above. As a result, domestic public borrowing would be necessary to fund a stimulus, the practicality of which is discussed in the next section.

Two technical arguments are presented to justify abandoning fiscal policy for economic management: the possible inflationary effect of deficits, and the putative tendency for public borrowing to “crowd out” private by causing interest rates to rise. We first consider the relationship between public deficits and inflationary pressures is analytically straight-forward.

An increase in spending from any source results in a reduction of expenditure of another type if an economy is at full potential. If the expenditure is by the public sector, its inflationary impact will depend on how it is financed. The expenditure can be financed through borrowing by sales of government securities to the private sector (“open market operations”) or by the ministry of finance borrowing from the central bank (“monetizing the deficit”). An increase in a public deficit is not inflationary if financed by bond sales to the private sector, because the net change in the money supply is zero. The government takes money out of circulation by the bond sale, and returns the same amount to circulation through its increased expenditure. Assuming

²⁰ In a study of Sierra Leone quarterly export revenue and government expenditure were used to estimate quarterly GDP (Weeks 2009d).

²¹ At the annual Caucus of African governors of the IMF, World Bank and African Development Bank held in Freetown in August 2009, a frequent criticism of IMF and World Bank practice by ministers was the slow-disbursing nature of lending and grant programs. This criticism was directed specifically at three programs of the IMF, the Extended Credit Facility (ECF), the Stand-by Credit Facility (SCF) and the Rapid Credit Facility (RCF). The ECF replaced the Poverty Reduction and Growth Facility (PRGF).

that the private sector holds its desired amount of bonds before the additional public borrowing, the government must offer the bonds above the prevailing interest rate. If the increased bond rate transmits to private financial markets and investment is sensitive to interest rates, “crowding out” results. In contrast, if the government borrows directly from the central bank, the money supply increases and inflation results, with an important exception. In an open economy part of the increased money in circulation will be spent on imports, reducing the inflationary impact, but creating or increasing a trade deficit.

If the economy is operating at less than full potential, neither type of deficit financing should generate more than minor and transitory inflation, though “crowding out” could occur. More government expenditure financed by bond sales to the private sector would bring a net increase in aggregate demand. As before, no change in the money supply occurs. Also as before, if the public held their desired amount of government debt prior to the bond sale, the new issues must be at a higher interest rate, creating upward pressure on private interest rates, depressing private investment expenditure. The net change in aggregate demand would be positive and less than the increase in public expenditure unless private investment is extremely interest rate elastic, which is extremely unlikely in the sub-Saharan region. Financing the expenditure by direct borrowing from the central bank would not require a higher bond rate. The increase in aggregate demand would equal the increase in public expenditure, and monetizing the deficit generates an increase in the money supply sufficient to circulate the increased output that results from more public expenditure.

Few sub-Saharan countries have sufficiently developed bond markets to allow for effective open market operations (see next section). In the absence of an effective secondary bond market the major motivation of commercial banks to hold public bonds is statutory requirements on the composition of reserves. This implies that high interest rates are required to induce banks to purchase bonds beyond their legal obligation. The absence of a secondary market and high yields on public bonds means that financing deficits by bond sales has the perverse effect of discouraging commercial banks from funding productive investments, which are riskier than

holding government securities.²² A second major effects of high interest rates is to increase the cost of servicing the domestic public debt.

With the economy well below its potential, monetizing the deficit is an effective tool for the expansion of aggregate demand, generating neither inflation nor “crowding out” of private expenditure. The government’s expenditures on infrastructure could be consciously designed to “crowd in” private investment by lowering costs of transport, electricity and water supply.²³ In many African countries, Zambia, for example, the increased cost of servicing the public debt as a result of bond sales should be a greater concern than inflation or “crowding out”.

3.4. Exchange Rate Management

Fiscal expansion, by increasing output and private demand, will increase imports and generate a trade deficit or make an existing deficit larger. This is one of the problems that undermined the use of active fiscal policy in developing countries in the past and discredited it as an instrument of macro management, especially in Latin America in the 1970s. Exchange rate depreciation or devaluation can be used to counter the tendency of fiscal expansion to create an unsustainable trade balance.

Thus, depreciation or devaluation is an intended part of a countercyclical policy, and causes a rise in the domestic price level equal to at least the “pass-through rate” (marginal propensity to import) times the change in the nominal exchange rate. While necessary and intended, this exchange rate induced increase in the price level creates the risk of destabilizing inflation if the nominal devaluation is large. Managing this risk is an essential part of a successful active fiscal policy.

As fashion moved against active fiscal policy over the last three decades, there was a shift to a view that “flexible” exchange rates were the only practical policy choice for governments. Therefore, it is necessary to explain why exchange rate management by African governments would be both feasible and possible as part of

²² This process is discussed in detail for Zambia in Weeks, *et. al.* (2006). This represents what might be called “bank squeezing out”. The typical use of the term “crowding out” refers to a fall in private investment that results from government borrowing that pushes up interest rates, discussed in the previous section. More relevant in sub-Saharan countries is the decision by private banks not to lend because the risk-adjusted return on public bonds is greater than that for lending to private non-financial borrowers. The return on public bonds is high because of the oligopsonistic power of private banks in sub-Saharan countries.

²³ An example is the repair of the Bumbuna hydroelectric site, which could greatly reduce power cuts and private generators in Sierra Leone, especially Freetown. See <http://siteresources.worldbank.org/EXTDEVCOMMENG/Resources/sierraleone.pdf>

policy to counter the global crisis.²⁴ In practice almost all governments intervene in foreign exchange markets.²⁵ The policy choice is not between “fixed” and “flexible” exchange rate regimes, but selection of the most appropriate point on a range of forms and degrees of intervention in the context of the characteristics of the economy (Fischer 2001). Governments and central banks repeatedly shift between “flexible” and “fixed” exchange rates.²⁶ Any time a central bank intervenes to moderate the rise or fall of the national currency it is “fixing” the exchange rate, however briefly.

The exchange rate management that would be part of the proposed stimulus package would not seek to maintain a “fixed” rate for the domestic currency against any foreign currency. The purpose of the intervention would be to control the rate of depreciation of the national currency against the currencies of major trading partners in order to prevent a widening of the trade gap as the economy expanded and prevent excessive weakening that would stimulate unmanageable inflation. The exchange rate managers would face two possible contexts, one in which the fiscal expansion was accompanied by no “weakening” of their currency and another in which fiscal expansion automatically provokes depreciation.²⁷

The *devaluation case* occurs if there is no market pressure to weaken the national currency as public expenditure increases. The government must act directly on the exchange rate, to raise the price of tradables, which will reduce import demand and raise the return to exporters. The mechanism for exchange rate management will differ with the characteristics of financial and foreign exchange markets in each country. In effect, the government would temporarily be implementing a “crawling peg” exchange rate regime. The *depreciation case* occurs if the fiscal expansion is

²⁴ An argument in favor of a return to managed exchange rates is found in Rolnick and Webber (1989), who write, “[W]e maintain there is a convincing case that a fixed exchange rate system is feasible and should be established. Theory shows it feasible, and overlooked empirical evidence shows it possible.”

²⁵ The IMF categorizes countries by exchange rate regime, and the Annual Report for 2007 lists only thirty-five out of over 150 as having an “independently floating” exchange rate. Only two were in the sub-Saharan region, Democratic Republic of Congo and Somalia. The listing of the latter seems an anomaly because Somalia has no government and no currency. Another anomaly is the absence of Sierra Leone from the table.

²⁶ Exchange rate management is treated in Rolnick and Webber (1989) and Bartolini and Prati (1997). An IMF Staff Paper from the 1970s shows how much the conventional wisdom has moved against exchange rate management (Lipschitz 1978).

²⁷ The well-known Fleming-Mundell model predicts that a fiscal expansion would result in exchange rate appreciation. That analysis is not relevant to most of Africa because the countries have no significant level of portfolio flows due to lack of the necessary financial institutions. Theoretical problems in the model are discussed in Weeks 2009b.

accompanied by market pressure to weaken the currency. While the market pressure to weaken the exchange rate serves the government's purpose of increasing competitiveness, intervention is potentially necessary to prevent the currency from depreciating at a rate that generates unmanageable inflation pressures.²⁸

In summary, the exchange rate can be an effective policy instrument for supporting a fiscal stimulus, especially important if monetary policy is ineffective. This effectiveness is limited by potential inflationary effects. However, for many governments in the sub-Saharan region exchange rate policy is precluded by currency arrangements, as discussed in the next section.

4. Feasibility of a Fiscal Stimulus

If a government could effectively use all its policy instruments the design of the stimulus package would follow the standard textbook prescription: an increase in expenditure or a reduction in taxes would provide the principle demand stimulus; the exchange rate would be managed to prevent deterioration in the external current account; and the fiscal deficit would be financed in part or entirely by public bond sales to the private sector to prevent excessive money growth. For countries that export exchange rate inelastic commodities, such as petroleum, currency adjustment would affect only imports.

However, the policy options facing the governments of the sub-Saharan countries are considerably more restricted than this, as Tables 1-4 show. If we ignore restrictions set by donors and lenders, policy space in the sub-Saharan region is restricted by two types of constraints, institutional and economic. As the first column of Table 1 shows, very few countries in the region have the basic institutions to implement monetary policy. As summarized in Table 2, seventeen countries were part of a common currency zone (fourteen) or operated with an inflexible link to the South African rand (three). Of the twenty-nine countries with national currencies, in eighteen governments did not issue bonds, or issued bonds but no formal bond market existed.²⁹ For the region as a whole, only eleven of almost fifty countries had secondary bond markets and only South Africa had an effective and relatively

²⁸ Exchange rate management in Zambia is discussed in detail in Weeks, *et. al.* (2007).

²⁹ The most accessible source for information on monetary institutions and financial markets in Africa is the Wharton Financial Institutions Center of the University of Pennsylvania, which provides recent reports on almost all countries. See <http://fic.wharton.upenn.edu>. For countries in Africa not covered in Wharton studies, websites of central banks were used.

efficient resale market.³⁰ For practical purposes, monetary instruments are of little use in the sub-Saharan region except for a few countries.

Though less limited than monetary policy, exchange rate adjustment is not available to a substantial number of sub-Saharan government, because, as noted above, fourteen have a common currency. Three more have chosen to maintain a strict link to the rand within the Common Monetary Area. Of the remaining twenty-seven, eight operated with adjustable fixed exchange rates and nineteen with managed or “flexible” rates. The majority of these twenty-seven had no bond markets in which sterilization operations could be implemented. For several of the twenty-seven, exports would be exchange rate insensitive (e.g., Angola and Nigeria, petroleum exporters).

With regard to fiscal policy (Table 3), the countries of the West African Economic and Monetary Union and Central African Economic and Monetary Community (so-called CFA zone) had restrictions on fiscal operations that required the governments to balance the annual current budget. The capital budget could be in deficit if the method of finance were specified. While this arrangement does not exclude a fiscal stimulus, in practice it greatly restricts it. The *sin qua non* of countercyclical intervention is that it can be initiated and terminated quickly in response to demand shocks. Capital expenditures lack this flexibility.

In addition to these primary institutional constraints on policy tools, there are the secondary ones stressed by the IMF, performance indicators. Some initial conditions would be so unfavorable as to render a stimulus package unwise because it would generate macro instability rather than recovery. In general, a stimulus policy should be consistent with a sustainable fiscal balance, manageable external current account and inflation which is not destabilizing. The initial values of these variables which are consistent with macroeconomic stability will dependent on the structural and behavioral characteristics of each economy and the size of the stimulus to be implemented. In this context, the most important behavioral characteristics are the exchange rate elasticity of trade, the propensity to import, the income elasticity of public revenue, and the degree of structural inflation.

³⁰ For example, the government of Zambia issues bonds and the Bank of Zambia conducts open market operations. However, the market for these bonds is narrow, limited to a few expatriate banks (Weeks, *et. al.* 2006, Chapter 6).

On the basis of the average import propensity and inflation rates for the region, and assuming low elasticities of trade and public revenue, the following performance guidelines are proposed. Prior to the implementation of the stimulus package,

1. the fiscal balance after concessional finance (ODA) should not exceed five percent of GDP;
2. the external current account deficit should be covered by ODA, and foreign exchange reserves should be at least three months of imports; and
3. inflation should not exceed fifteen percent per annum except in the case of a fiscal surplus.

Table 4 combines these performance constraints with the previously discussed institutional limits on policy implementation to identify the stimulus packages that would be feasible in the sub-Saharan region. Whether it would be appropriate to do so requires individual country analysis. For eighteen countries it would be feasible to implement a combined fiscal expansion and exchange rate management package. Despite its high inflation rate of eighteen percent, Angola is included in this group because of the country's large fiscal and current account surpluses.

In most of these countries it would be possible to finance the increased expenditure by bond sales because of functioning financial markets. For some, for example, Angola, Comoros, Gambia and Tanzania, it would be necessary to monetize the increase in the fiscal deficit. With the exception of South Africa, in none of the countries is it likely that foreign exchange operations by the central bank would be a safe method of exchange rate management.

The practicality of implementing a stimulus is verified by three of these countries initiating such packages in 2009 or 2010.³¹ The IMF supported the counter cyclical intervention in Mozambique, even though the government's fiscal deficit was over three percent of GDP and the external current account balance was almost minus nine percent of GDP. Almost all the countries in Table 1 that would use both fiscal and exchange rate instruments had smaller negative balances after ODA inflows.

For six countries exchange rate management would not possible due to currency arrangements, but their fiscal and current account balances allow for fiscal expansion (see Table 4). Fiscal expansion would threaten neither internal nor external

³¹ These are Sierra Leone (Weeks 2009d), Mozambique (IMF 2009c) and Nigeria (Alabi and Adams 2010).

stability. In ten countries a fiscal expansion would require external concessionary finance because of limits on deficit financing. In ten other countries the performance indicators do not justify a stimulus policy.

To summarize, in twenty-four of the forty-four countries, over half, a domestically financed fiscal stimulus would be feasible and justified by the most recent performance indicators. The performance indicators for ten more countries do not preclude a stimulus, but it would require external assistance because of the current account impact in the context of exchange rate inflexibility. Ten countries require stabilization program to move towards internal and external balance before a stimulus would be sustainable.

Table 1: Macroeconomic Indicators and Policy Tools Available to Sub-Saharan Governments, Late 2000s

Country	Monetary policy	Fiscal policy	Exchange rate policy	Fiscal deficit	Crr Acc deficit	Forex reserves	ODA/GDP	Inflation
Angola	NSM		Managed	6.5	19.3	4.2	0.9	18.2
Benin	NCB	Constrained	WAEMU	-0.2	-5.0	7.0	8.3	4.5
Botswana	NSM		Managed	11.4	18.4	21.3	0.7	14.5
Burkina Faso	NCB	Constrained	WAEMU	-5.0	-11.2	na	13.9	2.1
Burundi	NSM		Managed	-1.9	-13.7	4.1	46.8	13.5
Cameroon	NCB		CAEMC	4.1	-1.7	5.0	9.4	1.8
Cape Verde	LSM		Fixed (Euro)	-2.2	-10.2	3.3	11.7	4.3
Cen Afr Rep	NCB		CAEMC	-0.5	-8.2	na	8.8	3.6
Chad	NCB		CAEMC	-1.9	-2.0	na	6.5	10.7
Comoros	NSM		Fixed (Euro)	-2.0	-5.0	na	7.8	3.7
Congo DR	NSM		Managed	-2.0	-26.4	na	21.5	18.1
Congo, Rep	NCB		CAEMC	6.0	-8.0	3.4	3.3	7.5
Cote d'Ivoire	NCB	Constrained	WAEMU	-1.1	1.1	2.8	1.3	5.4
Eq Guinea	NCB		CAEMC	21.0	5.7	na	0.6	19.9
Eritrea	NSM		Fixed (US\$)	-30.0	-12.0	na	17.4	17.5
Ethiopia	NSM		Managed	-7.6	-8.2	2.1	13.7	16.8
Gabon	NCB		CAEMC	14.8	11.0	2.4	0.5	9.7
Gambia	NSM		Managed	0.5	-10.5	4.3	14.3	3.8
Ghana	LSM		Managed	-7.3	-11.3	3.2	8.5	5.8
Guinea	NSM		Fixed (US\$)	-3.3	-8.0	na	5.4	18.0
Guinea-B	NCB	Constrained	WAEMU	-19.1	2.4	na	28.9	5.8
Kenya	LSM		Managed	-2.6	-3.5	3.7	4.5	9.0
Lesotho	CMA		CMA (rand)	8.7	8.5	4.8	4.7	7.9
Liberia	NSM		Fixed (US\$)	0.3	-28.5	0.6	80.2	12.8
Madagascar	LSM		Managed	-2.6	-10.0	2.7	14.8	12.3
Malawi	LSM		Managed	-2.5	-5.5	na	21.0	13.4
Mali	NCB	Constrained	WAEMU	8.0	-6.2	4.6	14.2	6.1
Mauritania	NSM		Managed	-5.0	-20.0	na	10.2	15.1
Mauritius	LSM		Fixed (basket)	-2.7	-8.8	3.5	0.6	7.3
Mozambique	NSM		Managed	-3.4	-9.9	3.8	23.5	8.5
Namibia	LSM		CMA (rand)	-4.5	11.2	3.2	2.1	10.6
Niger	NCB	Constrained	WAEMU	12.5	-8.0	3.3	14.1	5.1
Nigeria	LSM		Managed	0.9	-5.3	9.5	1.7	9.6
Rwanda	LSM		Managed	-0.2	15.0	6.8	22.2	11.7
Senegal	NCB	Constrained	WAEMU	-1.5	-10.4	3.6	8.2	4.9
Seychelles	NSM		Fixed (basket)	-1.8	-16.3	0.9	0.8	4.2
Sierra Leone	NSM		Managed	-5.0	-8.6	4.3	29.4	11.7
South Africa	ESM		Managed	1.5	-7.4	na	0.3	9.0
Sudan	NSM		Managed	-0.4	-10.1	1.5	6.1	10.4
Swaziland	NSM, CMA		CMA (rand)	-2.8	-4.8	2.8	1.8	6.2
Tanzania	NSM		Managed	-3.5	-9.6	5.3	13.7	10.9
Togo	NCB	Constrained	WAEMU	-3.4	-15.3	2.1	4.2	1.8
Uganda	LSM		Managed	-1.0	-5.9	6.9	14.7	3.6
Zambia	LSM		Managed	-1.1	3.8	3.1	14.2	13.3
Totals	Feasible monetary policy 12/44	Feasible fiscal policy 37/44	Feasible exchange rate policy 27/44					

Notes to Table 1:

Countries omitted due to incomplete data: Djibouti, Sao Tome and Principe, Somalia and Zimbabwe.

Shaded cells indicate values or characteristics that restrict policy options.

Indicators (2006-07 or last two years that were available):

Fiscal deficit is the cash deficit as a percentage of GDP.

Crr Acc deficit is the current account of the balance of payments as percentage of GDP.

Forex reserves are central bank holding of foreign exchange measured in months of imports.

ODA/GDP is official development assistance (OECD definition) as percentage of GDP.

Inflation is the annual rate of change of the GDP deflator.

The first three cells of the final row give the number of countries out of the total for which each policy instrument is feasible. Fiscal expansion is judged as not feasible if: the fiscal deficit exceeds the share of ODA in GDP by more than five percentage points; the current account deficit exceeds the ODA share by more than five percentage points; foreign exchange reserves are less than three months of imports; and/or inflation exceeds fifteen percent.

Acronyms:

The so-called CFA franc zone is the West African Economic and Monetary Union (WAEMU, Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo). In addition to a common currency the governments of these countries are constrained to balance the current account of the public budget. The capital account can have a deficit if the method of funding the deficit is specified. The Central African Economic and Monetary Community (CAEMC, Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon) also has a common currency with a fixed parity to the euro. Both are commonly called the CFA franc. They are not freely interchangeable, except via euro convertibility that is guaranteed by the French Treasury, which holds at least sixty-five percent of the pooled reserves of each area.

CMA is Common Monetary Area, rand (South Africa, Lesotho, Namibia, Swaziland)

NCB is no central bank, including countries sharing a common central bank.

NSM is "no secondary market" which includes cases in which the government does not issue bonds, issues them but does not sell them on the open market, or sells them but there is no secondary (resale) market.

LSM is "limited secondary market" and refers to the number of buyers and sellers.

ESM is "effective secondary market".

Fiscal deficit includes grants and other revenue on income side.

Sources:

Monetary institutions: Wharton Financial Institutions Center of the University of Pennsylvania, all but Mauritius, Namibia, Nigeria and Seychelles, and <http://www.afdb.org/en/news-events/article/donor-workshop-on-african-bond-market-4443/>

Economic indicators: World Development Indicators 2009 and IMF country reports.

Table 2: Sub-Saharan Countries, Monetary Institutions, 2010

Category	Notes
Common Currency	(17) WAEMU, BEAC, CMA
National currency	(27) fixed or managed
No bond market	(16) no bonds or no re-sale market
Bond market	(11) formal re-sale market
Narrow Effective	(10) usually commercial banks only
	(1) South Africa

Table 3: Sub-Saharan Countries, Exchange Rate Regimes, 2010

Category	Notes
Common Currency	(17) WAEMU, BEAC, CMA
Single currency, fixed	(8) US\$ (3), Euro (2), basket (3), 3 with bond market
Single currency, managed	(19) 8 with bond market

Table 4: Sub-Saharan Countries, Fiscal Policy Summary, Late 2000s

Category	Countries
1. Excluded from domestic financing because constrained to balance current budget	(14) Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo, Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon
2. Excluded by fiscal deficit (Fiscal deficit - ODA) < (-5% GDP)*	(2) Eritrea, Ethiopia
3. Excluded by current account deficit (Current account - ODA) < zero*	(4) Guinea, Mauritania, Seychelles, Togo
4. Excluded by forex reserves (Forex reserves) < (3 months of imports)	(3) Liberia, Madagascar, Sudan
5. Excluded by inflation [Inflation over 15%]*	(2) Angola, Congo DR
<u>Feasible</u> : Domestically financed fiscal expansion with exchange rate management	(18) Angola, Botswana, Burundi, Cape Verde, Comoros, Gambia, Ghana, Kenya, Malawi, Mauritius, Mozambique, Nigeria , Rwanda, Sierra Leone , South Africa, Tanzania, Uganda, Zambia
<u>Feasible</u> : Domestically financed fiscal expansion, no exchange rate management [fiscal surplus, strong current account]	(6) Cameroon, Eq Guinea, Gabon, Lesotho, Namibia, Swaziland
<u>Feasible</u> : Externally financed fiscal expansion, no exchange rate management	(10) Benin, Burkina Faso, Cen Afr Rep, Chad, Congo Rep, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal
<u>No stimulus feasible</u> : excluded by fiscal deficit, current account deficit or inflation	(10) Eritrea, Ethiopia, Guinea, Mauritania, Seychelles, Togo, Liberia, Madagascar, Sudan, Congo DR

Countries in bold initiated fiscal stimulus in 2009 or 2010.

*Countries in previous categories excluded.

5. Constraints on Macro Policy

The low level of development of financial institutions renders monetary policy ineffective in the vast majority of the sub-Saharan countries. Common currency arrangements further limit the policy options of many governments. In some countries policy options are further limited by size of the fiscal deficit, current account imbalance, foreign exchange reserves and inflation.

However, as the Freetown Declaration of African finance ministers stated, these constraints limit but do not preclude purposeful policy in which governments of the region assert themselves as agents of short term recovery and long term development. For a few governments active policy intervention can be done through a balance of all the standard instruments, fiscal, monetary and exchange rate. For a majority fiscal policy with domestic deficit financing can be used to re-commission the public sector as an agent of change. In three-quarters of the countries purposeful action is consistent with macro stability.

However, the governments need donors and the IMF to grant “policy space” through the following measures, specified in the Freetown Declaration:

- 1) elimination of the pro-cyclical conditionalities and “benchmarks” for deficit limits, inflation rates, external borrowing and foreign exchange holdings (all explicit in the Declaration);
- 2) donor reliability on delivery of assistance because the stimulus policies will be “finely tuned” and late or non-delivery of assistance could provoke macroeconomic instability; and, more generally,
- 3) a suspension of the “business as usual” approach to negotiations over development assistance which emphasizes “reform” issues that the external crisis has rendered of less immediate importance.

The combination of a carefully calibrated stimulus policy and donor flexibility offers the firm prospect of overcoming the potentially serious effects of the external shocks from the international financial crisis. While a stimulus package involves risks, they are minor compared to the certain effect of the global recession on poverty and public welfare.

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