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Can Low-Income Countries Adopt Counter-Cyclical Policies?

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The current global recession reconfirms low-income countries' vulnerability to external shocks. The exposure is a direct result of integration into the world economy. Declines in export earnings, remittances, tourism and capital flows are some of the transmission mechanisms. The developed and middle-income countries have responded with a series of stimulus packages. More to the point, they are able to adopt counter-cyclical policies. Can low-income economies do the same?

In this One Pager we argue it is possible. What is needed is a rejection of the *price-determined economy* framework in macroeconomic policy analysis, and in its place the adoption of the *demand-determined economy* framework. The theoretical distinctions between the two frameworks imply fundamental policy differences.

Price-Determined Economies

A price-determined economy is either in a unique full employment general equilibrium, or prevented from achieving it by price "distortions". All markets clear instantaneously. Any action by private or public agents to inhibit market adjustment in prices will result in an outcome below full employment. This implies that fiscal and monetary policy should be "neutral" and "passive".

Fiscal policy would be "neutral" in that: (i) taxes should not affect the decision of private agents between income/consumption and leisure; (ii) neither taxes nor expenditures should affect the relative profitability of commodities; (iii) government should not distort capital markets by competing with private agents; and (iv) the inherently distorting operations of the public sector should be minimised: taxes should be levied on a uniform basis and fiscal deficits should be minimised.

The theoretical basis for the price-determined framework is weak. It cannot be demonstrated that the full employment price set is unique, which calls into question the concept of "distortions". If there is more than one non-distorted outcome, one cannot be sure that the prices in an economy with public sector interventions are substantially different from non-distorted outcomes.

Consider this apparently simple statement: "tariffs distort profitability between importables and exportables". The validity of this statement requires the prior demonstration of the existence of a unique full employment general equilibrium. Since this cannot be demonstrated generally, even in theory, the correct statement would be, "tariffs alter profitability between importables and exportables". This is the core of the policy debate. If public sector actions distort the economy, that results in inefficiency, then such actions should be avoided or minimised. If the actions alter the economy, then a subjective policy assessment is required to determine whether the alteration is beneficial to society.

Demand-Determined Economies

An economy is demand-determined when its level of output is limited by one or all of the components of aggregate demand: consumption, private investment, government expenditure, or exports. In this framework, relative prices change as the level of aggregate demand rises and falls. Hence relative prices are not "signals" to producers and consumers, but result from their production and consumption decisions. Since prices do not determine quantity choices by consumers and producers, they are derived *from* them; they are not pointers of efficient allocation. Public sector interventions, therefore, should be judged on a pragmatic basis in terms of social cost and social benefit. The criterion for judgement should be whether taxes and expenditures achieve the goals set by society; when those goals conflict, an empirical analysis of trade-offs is required.

If one moves from the ethereal world of the abstract to the characteristics of low-income economies, it should be obvious that the price-determined framework is not applicable. First, most of these economies, such as those in Sub-Saharan Africa, are still advised to constrain demand through high real interest rates and fiscal austerity, and in some cases by heavy debt burdens. Second, as the current crisis reveals, many of the economies are suffering from transmission of shock through contraction in external demand. Third, major prices are not primarily market-determined. It is obvious that the nominal interest rate is an administered price if the monetary authorities practice inflation targeting. In addition, aid flows and debt servicing represent a substantial portion of the balance of payments, and neither is directly sensitive to the exchange rate. As a result, the value of a "floating" exchange rate is determined by non-market flows.

The current global recession is a demand constraint. The need to adopt counter-cyclical policies to unlock this constraint requires interventions to be "distortionary". In the short and medium run this involves counter-cyclical policies, and in the long run public investment that increases aggregate supply.

A country-specific policy package that recognises economies to be demand-determined would have the following components: (i) an expansionary fiscal budget, consistent with the rule that the overall deficit not exceed public investment; (ii) an accommodating monetary policy that tolerates moderate inflation in order to achieve higher growth by providing subsidised credit for poverty reduction programmes (the target could be that the real interest rate equals the sustainable growth rate of per capita income—the Golden Rule); and (iii) a managed exchange rate regime that seeks to promote exports and alter the relative price of tradeables and non-tradeables without causing unmanageable inflation spirals.

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