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Prioritizing Economic Growth: Enhancing Macroeconomic Policy Choice

Colin I. Bradford, Jr.

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Division on Globalization and Development Strategies, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums.

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**PRIORITIZING ECONOMIC GROWTH:
ENHANCING MACROECONOMIC POLICY CHOICE**

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Abstract

This paper spells out a logic for increasing macroeconomic policy space in order to prioritize the goals of growth, employment creation and poverty reduction.

First, there is the need to create additional policy instruments so that a greater number of policy goals can be addressed. Frequently, real economy goals get partly crowded out by financial objectives because there are too few instruments for too many goals. Second, the calibrated use of policy tools by degrees of commitment, deployment and assignment can create space for different policy-mixes. Selective capital controls, intermediate exchange rate regimes, and some monetary policy autonomy create the policy space within which a variety of policy combinations and mixes are possible and a greater number of instruments are available. Prioritization of real economy goals becomes both more feasible and more likely with a broader range of policy alternatives. Third, along with selective use of capital controls, fiscal policy-based stabilization instead of exchange rate-based stabilization delinks the exchange rate from the goal of internal financial stability to which it is yoked in a regime of fixed exchange rates. This delinkage enables the use of intermediate exchange rate regimes (soft pegs and managed floating). The use of these regimes in “the missing middle” between fixed and flexible exchange rates creates policy space where different mixes are possible generating a greater range of policy alternatives. Fourth, prioritizing real economy goals is also facilitated by the design of a larger strategic framework for accelerated development including institutions, norms, behaviours and governance. The larger strategic framework mobilizes more assets and power toward a dynamic growth trajectory that creates a more favourable context for macroeconomic policy. The impact of macroeconomic policies on growth, employment creation and poverty reduction is likely to be stronger when they are part of a wider effort to marshal resources for accelerated development. The examples of the East Asian success stories provide the evidence for this conclusion.

These four steps in the logic for increased macroeconomic policy choice – new policy tools, selective and pragmatic use of capital controls and exchange rate intervention, fiscal policy-based stabilization, and strategic frameworks – reinforce each other in their capacity to create more policy space.

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PRIORITIZING ECONOMIC GROWTH: ENHANCING MACROECONOMIC POLICY CHOICE*

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... while the new policy direction has successfully uprooted the previous regime it has failed to establish a flourishing alternative. More worrying still, in terms of future prospects, has been the loss of policy autonomy, at both the microeconomic and macroeconomic levels, and the narrowing of the room for policy manoeuvre. Rubens Ricupero, Secretary General of UNCTAD (UNCTAD, 2003: XII)

Recent economic policy experience in developing countries has led many to conclude either that there is no “policy space” for economic policy alternatives and/or that mainstream economic policy practice is highly deflationary. The lack of choice would seem to weaken democratic process in developing countries limiting the role of public discussion, debate and decision in economic policy-making. And the perceived priority of financial stability over real economy objectives of economic growth and greater employment feed a sense that there are biases in the globalization process and in the international financial institutions which appear to preside over it. As a result, there are strong motivations for exploring the degree of macroeconomic policy choice, both from internal political and economic perspectives and from the point of view of the international debate.

This paper attempts to lay out a logic for the notion that macroeconomic policy can indeed play a role in stimulating economic growth and employ-

ment, despite the many realistic constraints on its conduct. The soundness of the argument is important to the international economic agenda and the mechanisms for global governance, for if there is indeed no room for macroeconomic policy choice, then there is less reason to strengthen the “voice” of developing countries in the global governance. If “one size fits all”, then the boundaries on both debate and decision are tightly drawn undermining the need to hear and accommodate differing perspectives on macropolicy in the international community.

However, recent experience also suggests that financial stability is not sustainable without social improvement, and that poverty reduction and enhanced equity are not sustainable without financial stability. Today, the IMF and the Lula administration in Brazil both seem to recognize these interconnected policy imperatives and to be locked in a dance together in which the fate of each depends on the other. *As a consequence, being able to prioritize*

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growth, employment, poverty reduction and equity are critical for the sustainability of policy reform efforts. Without a sense of policy options, national governments may be less inclined to participate in global integration and governance. The presidents of Argentina and Brazil met in the fall of 2003 and signed a “sweeping statement, dubbed the Buenos Aires Consensus, as a rejoinder to the Washington Consensus...The statement promised to generate jobs, not just profit, and fight for fair, not just free, global trade” (Smith, 2003).

This paper deals with policy alternatives, policy constraints and policy experiences. The first three sections develop the logic for enhanced policy space developed from the analytics of the assignment of instruments to objectives within open and closed economies and under fixed and flexible exchange rate regimes. The second set of three sections addresses the pressure of markets on policy practice, especially fiscal policy, and the degree to which there is policy space in the exchange rate policy debate and experience. The last two sections give an overview of recent policy experiences in both Latin America and East Asia in revealing limitations and opportunities for exercising macropolicy choice.

I. Policy objectives and policy instruments

Tinbergen taught us that for economic policy to work, there needs to be at least as many policy instruments as there are policy goals (Tinbergen, 1956). This principle, as we shall see, is difficult to implement in a world of multiple objectives and imposing constraints. Mundell helped carry this principle forward in the early 1960s when he articulated the idea of “assigning” each instrument of macroeconomic policy to different policy objectives in an effort to achieve *internal and external balance at the same time*, something that was at the time becoming increasingly important due to the growing openness of national economies to the world economy (Mundell, 1962: 70–77). As William Branson observed many years later, the Mundellian framework normally assigned fiscal policy to internal balance, by which was meant the reduction of inflation, while exchange rate policy was assigned to the trade balance or the current account, and monetary policy was assigned to foreign exchange reserves or the capital account (Branson, 1995: 116).

This is at once an ingenious and problematic framework for it reveals even today the underlying policy tensions at work which are driving both discouragement about policy space and debate about future policies. The deflationary bias implicit in this assignment is clear. Contractionary fiscal policy is necessary to bring down aggregate demand driven inflation. Contractionary monetary policy is necessary to keep the domestic interest rate higher than the world interest rate to attract foreign capital. And exchange rate devaluations, which restrict imports even though exports expand, are necessary to shrink the trade deficit.

While these policies are effective means of achieving financial stability, the entire set of macropolicy tools are essentially used up to avoid excessive inflation and external imbalances leaving no tool remaining to assign to economic growth and employment generation. *There are essentially too few instruments to achieve financial stability and economic growth at the same time.* The 3x3 tool-target matrix leaves out the real economy goals of economic growth and employment generation (chart 1). This conundrum creates incentives for thinking about how to increase the number of policy instruments so that real economy objectives (growth and jobs) can be prioritized within the standard policy framework formulated by Mundell. It also reveals the need to think creatively about how to manage economic policy trade-offs to preserve manoeuvring room for policy makers so they in fact have options and choices. Preserving policy space seems all the more difficult against the background of recent policy experiences in several high visibility cases of economic policy crises in which there has been intense pressure to give up policy instruments, reducing the total number of instruments available rather than increasing them, making the challenge of addressing real economy goals even more difficult.

II. Closed versus open economies

One way to get a grip on why the current policy conundrum is so vexing, is to think about the Mundellian policy framework in closed economies. In *closed economies*, there are essentially only two macropolicy instruments, fiscal and monetary policy. But there are only internal policy goals, since external targets are proportionately less important in closed economies. Despite the presence of only two

Chart 1

ASSIGNMENT OF POLICY TOOLS TO POLICY GOALS UNDER FLOATING EXCHANGE RATE(*) AND FIXED EXCHANGE RATE (#) REGIMES

	Price stability	Current account balance	Capital account balance	Economic growth
Fiscal policy	*	#	-----or-----	#
Exchange rate	#	#	*	#
Capital controls				
Monetary policy			*	

Note: In floating rate regimes, the capital account is assumed to be fully open, i.e. monetary policy has to be assigned to the capital account. Thus, the three macropolicy tools are assigned to three targets, which means that growth is in effect crowded out.

In fixed exchange rate regimes, monetary policy autonomy is foregone and the capital account is assumed to be fully open removing capital controls as an instrument of macropolicy. In the trade-off between assignment to the current account and economic growth, fiscal policy tends to be assigned to external balance rather than internal growth. The exchange rate becomes an anchor for achieving internal price stability with spillover effects on external balance.

instruments, the absence of two goals for external balance means that there can be an internal prioritization of employment generation through economic growth as well as a goal for financial stabilization through reducing inflation. In this world of two tools for two domestic targets, fiscal policy could be assigned in a Keynesian way to employment and growth, while monetary policy could be assigned to price stability. In a closed economy, the exchange rate is not important in determining domestic economic conditions because exports are a small share of GDP. And, also, the tight linkage in open economies between interest rates and the exchange rate is not as rigid in relatively closed economies.

In *open economies* with flexible exchange rate regimes, expansionary monetary policy leads to interest rate declines, in which case the exchange rate must rise (depreciate) to off-set the decreased returns

in the domestic market caused by looser monetary policy. Conversely, with contractionary monetary policy in open economies, higher interest rates result inexorably in a lower exchange rate (appreciation) to equalize returns in all markets in a world of integrated capital markets and open capital accounts. In open as opposed to closed economies, the exchange rate is the shock absorber and adjustment mechanism that restores equilibrium when there has been a policy shift internally or a policy shock externally. This is one advantage of floating exchange rate regimes.

Open economies, nonetheless, face a more difficult set of policy options than closed economies both because of the addition of the two external goals of current and capital account balance, and also precisely because in open economies with floating exchange rates, the interest rate and the exchange rate are rigidly linked to each other so that a variance in one forces an off-setting variation in the other.¹ These two facts together mean that it is very difficult if not impossible to assign monetary policy to an *internal* goal, whether price stability or employment, because the rigid link to the exchange rate *requires* that monetary policy be assigned to external balance. Now, these facts push macropolicy back to the situation of too few instruments for too many goals. In this situation common to open economies, *the real economy goals of employment and growth tend to get sacrificed to the financial goals of deflation and correction in the balance of payments* which generally are more immediate and more pressing. External crises, depleting foreign exchange reserves, take precedence over *any* other priority.

III. Floating versus fixed exchange rate regimes

There are basically four types of exchange rate regimes: floating, fixed, pegged and managed-intervention regimes. Floating exchange rates are market determined. They have the advantage of being very adaptive to changes in internal and external circumstances and the disadvantage of leading to potentially volatile exchange rates. Fixed rate regimes, such as currency boards, are usually agreed to for extended periods thereby having the advantage of exchange rate stability which can play a major role in achieving price stability but the disadvantage of surrendering monetary policy autonomy. A pegged

exchange rate regime is one in which the government establishes the exchange rate as a matter of policy and the central bank intervenes in foreign exchange markets buying and selling foreign exchange to support the “peg” until the government shifts policy when it designates a new rate. A managed-intervention regime usually means the establishment of a “soft” peg or dirty float, including an exchange rate band (say, plus or minus 2.5 per cent above and below a designated rate which may or may not be announced) which the central bank sustains by selective intervention in exchange and money markets.

The essential issue for the discussion here is that *the type of exchange rate regime chosen has significant implications for the degree of macropolicy discretion open to governments*. For example, in a pegged exchange rate regime, the exchange rate becomes a policy *instrument* whereas in a floating rate regime the exchange rate often becomes a policy *target* which requires that monetary or fiscal policy or both discipline themselves in order to sustain the floating rate at some reasonable level. It is the case (though it will not be demonstrated here) that *only* monetary policy is effective in floating rate regimes in stimulating growth in GDP. Fiscal policy for growth in floating rate regimes induces higher interest rates and exchange rate appreciation which nullify the growth stimulus from expansionary fiscal policy.

As a result, the policy problem in *floating rate regimes* is that monetary policy would have to do double-duty on both the internal and external fronts if growth were to be a priority. If fiscal policy is assigned to inflation, the exchange rate to the current account and monetary policy to the capital account and the exchange rate, monetary policy can not be assigned to internal real economy objectives. *This is in effect a 3x4 tool-target situation in which the conundrum of too few instruments for too many goals reappears in which growth is crowded out* (configuration * in chart 1). Even though in floating rate regimes monetary policy “works” to improve conditions in the real economy by stimulating economic growth, it is pre-empted from doing so by the rigid linkage between interest rates and exchange rates and the primacy of the exchange rate stability over income growth. If the exchange rate weakens, interest rates must rise to appreciate the exchange rate before any other consideration. If monetary policy is assigned to both internal growth and external sta-

bility, then growth would require expansionary monetary policy while external stability would require contractionary monetary policy. Balance of payments and exchange rate concerns generally predominate over economic growth considerations in these circumstances, so the goal of growth gets sacrificed.

In a *fixed exchange rate regime* for the long-run, market pressures that generate nominal exchange rate equilibrium points above or below the fixed nominal rate must be responded to by the central bank. If the expectations of currency holders shift toward a de facto depreciated level for the exchange rate, the central bank would have to sell dollars to take local currency out of circulation to restore the market-determined nominal rate to the fixed nominal rate. This reduction in the money supply causes interest rates to rise leading to declines in output or income from what they would have been under a floating rate regime. *The force field affecting macropolicy under a fixed rate regime dampens the rate of economic growth and restricts the capability of monetary policy to stimulate growth*. This is the cost in real economy terms for the financial stability achieved both in the exchange rate and in the price level. Monetary policy autonomy is lost and the priority of real economy objectives are made secondary to financial objectives because of the deflationary pressure on monetary policy of a fixed exchange rate regime.

However, it is also the case (though it will not be demonstrated here) that only fiscal policy is effective in stimulating growth in output and incomes (GDP) under fixed exchange rate regimes even though fiscal policy is not effective in flexible, market-determined exchange rate regimes. In principle, it should be possible to stimulate economic growth with fiscal policy in a fixed rate regime. The now-familiar conundrum of too few instruments for too many goals reappears. Since exchange rate policy is locked to price stability as an exchange rate anchor in a fixed rate regime and monetary policy autonomy is lost as a consequence, fiscal policy is the only macropolicy instrument left. Policy makers are forced to choose between assigning fiscal policy to the internal goal of growth or to the goal of external balance (configuration # in chart 1). External stability in the short-run, both exchange rate stability and balance-of-payments financing, normally pre-empts the long-run growth trajectory of the economy. This forces policy makers to contract fiscal policy to

achieve external balance rather than stimulate the economy to achieve growth in incomes and jobs.

Therefore, under both flexible and fixed rate regimes there are forces pushing macropolicy toward a deflationary impact on the economy for the sake of financial stability rather than toward stimulating economic growth for the sake of social stability. In the current circumstances and after recent experiences in the wake of the Asian financial crisis in the 1990s, this is an unacceptable set of policy choices for most governments in developing countries, especially for those that are democratically elected. This leads to a search for enhancing the space for macropolicy choice, especially for developing countries with enormous numbers of people in poverty left behind by insufficient and unsustainable rates of economic growth.

IV. Selective pragmatism

Markets are extraordinarily powerful mechanisms. No set of people knows this better than those who are or have been ministers of finance or central bank presidents. If market forces are pushing major macropolicy variables like the real exchange rate or the real interest rate away from their nominal values and governments are trying to force equilibrium or maintain divergence against the grain of the market, there is a limit to how long the government policy can prevail over markets. This is not an ideological statement based on value preferences. It is a fact of economic life that determines the range within which reasonable, effective economic policy can be forged. Wishful thinking does not work. Only policies that are within a set of boundaries that are realistic in terms of market pressures are feasible policies. The search for larger policy space for macropolicy choices has to be driven by rational pragmatism based on realities rather than by idealism based on hope or ideology based on hidden political agendas.

A useful framework for thinking about policy options in this context is the trilemma. The trilemma posits three desirable policy positions known as “the impossible trinity” and the trade-offs between them. All countries, undoubtedly, wish to have a stable exchange rate, an open capital account, and autonomous monetary policy. The trilemma helps make clear that these three desiderata are actually trade-offs. Policy makers are forced to be on one of the

three sides of the triangle on a line embracing only two of the three desiderata and foregoing the third (see chart 2). From the above analysis of fixed and flexible exchange rate regimes, it is clear that a currency board can achieve a stable exchange rate with an open capital account but only *at the expense of an autonomous monetary policy*. A floating rate regime can restore monetary policy autonomy with an open capital account *at the cost of some potential exchange rate volatility*. Similarly, implementing capital controls can also restore monetary policy autonomy with exchange rate stability but *at the cost of free capital movements*.

Whereas the trilemma shows that there is a need to choose which of the two desiderata are preferred, it is also the case that there is not a requirement to go to what John Williamson has called “the corner solutions” (Williamson, 2000). It is possible to engage in *selective* capital controls and a *managed-intervention* exchange rate regime which reclaims *some* monetary policy autonomy. *These moves away from the corners create more policy space within the original triangle of the trilemma (above) bounded by the more extreme positions of fixed exchange rate, entirely open capital account and fully autonomous monetary policy.*²

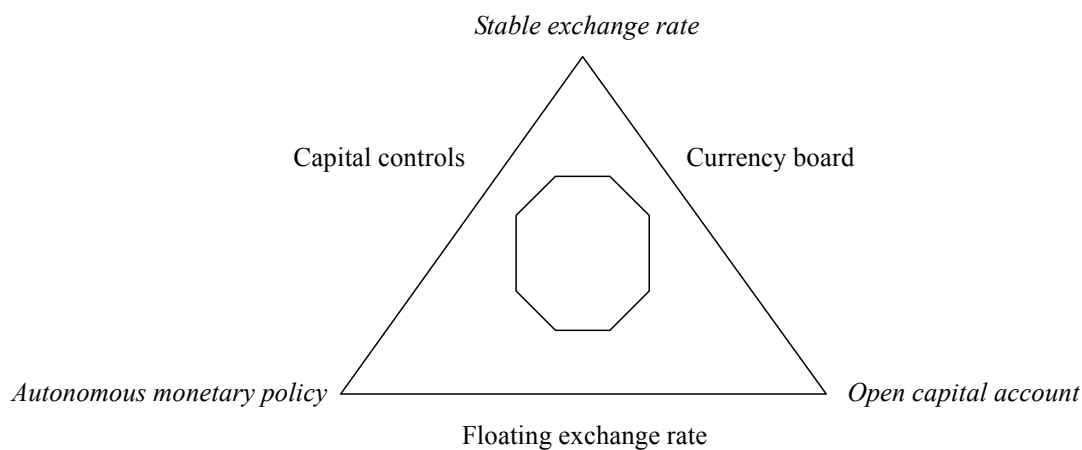
This policy space creates two opportunities to enhance the range of macropolicy choice. One is to provide opportunities for different *mixes* of policy instruments in which the degrees of deployment of each policy tool can be calibrated to fit specific circumstances. *This is a significant difference from a policy setting of either-or choices and corner solutions*. Second, this enhanced policy space allows countries to have four macropolicy instruments – fiscal, monetary, and exchange rate policies and partial capital controls – which permit the country to pursue four policy goals: price stability, current and capital account balance, and *growth*.

This innovation in policy stances is feasible because moving toward *the pragmatic middle*³ instead of the extreme “corners” enlarges the number of goals it is feasible to pursue due to enlarging the number of instruments that are available. Capital controls and exchange rates cease to be “corner solutions” and can be “assigned” to specific goals, increasing the number of policy tools to match the number of policy goals.

Therefore, *there are three major steps that achieve enhanced policy space: the idea of fiscal*

Chart 2

TRILEMMA



Note: Extreme policy stances in the corners, such as completely open capital account, fully autonomous monetary policy or fixed exchange rate regimes force policy choices on the lines connecting the corners of the triangle, meaning that one of the three options is foregone. Pragmatic policy stances of selective capital controls, some monetary policy autonomy and managed exchange rate regimes create a policy space within the triangle in which different policy combinations can be developed.

policy-based stabilization replacing exchange rate anchors; *intermediate exchange rate regimes* replacing the extremes of fixed versus floats; and *selective capital controls* replacing the false dichotomy of fully open versus fully controlled capital accounts.

V. Fiscal policy-based stabilization

One of the reasons why countries have been backed into the corners of the trilemma is that they themselves have failed to sufficiently discipline fiscal policy, and to a lesser extent monetary policy, to sustain a stable economy and exchange rate. The classic case is Argentina which for decades could not as a nation maintain fiscal discipline which spilled over into rapid inflation, balance-of-payments crises, external debt excesses, and political upheavals. Finally, in the early 1990s, an innovative finance minister, Domingo Cavallo, turned the economy on its head by getting Congress to pass a Constitutional amendment establishing a currency board of one Argentine peso equal to one dollar (Corrales, 1997; and

Dominguez, 1997). This policy move effectively “assigned” the exchange rate to internal price stability and used it as an anchor for domestic prices to halt the momentum of hyperinflation. Monetary policy autonomy was sacrificed to support the currency board. Open capital accounts were maintained to provide an avenue for financing current account deficits. Only fiscal policy remained. In this context, fiscal policy should have been assigned to external balance since exchange rate policy had in effect taken over from fiscal policy to achieve price stability.

But since fiscal policy “works” in fixed exchange rate regimes, under the currency board fiscal policy in Argentina was de facto available for double-duty as an instrument for stimulating economic growth. Given Argentina’s anomalous relationship between the central government’s sole responsibility for revenue raising and expenditure autonomy of state governments, fiscal discipline was impossible to maintain. Continuous fiscal deficits within a fixed exchange rate regime eventually acts like steam in a pressure cooker. The economic meltdown in Argentina following the failure of the currency board was

one of the most devastating economic crises of modern times. *One of the conclusions from this experience has to be that fiscal discipline is a sine qua non for economic policy regardless of whether the exchange rate regime is fixed or flexible or a mix* (Mussa, 2002: 6). This is an old lesson, articulated long ago in the economic literature, but hard to implement in the world of policy practice.

For the future, it seems essential to insist that exchange rate stability and economic stabilization more generally depend upon fiscal policy discipline regardless of the type of exchange rate regime. It would seem to be more effective to have fiscal-based stabilization programmes than to use exchange rates as anchors for achieving price stability. In the rear view mirror, exchange rate-based stabilization programmes look like furtive attempts to escape the fiscal policy straight jacket which, it now must be realized, has to be worn whether it feels good or not and whether the exchange rate is fixed or flexible.

With this notion of fiscal policy-based stabilization as a guide, fiscal policy can be assigned to price stability with the important implication that *fiscal discipline will now be the primary foundation for exchange rate stability*. This occurs both directly through controlling the price level and through controlling the expected exchange rate. One could even think of this assignment as *fiscal policy-based exchange rate policy*.⁴ The additional instrument of capital controls is assigned to the capital account. The exchange rate is assigned to the current account instead of to price stability as under a currency board. With this configuration, monetary policy is available to be used as an instrument for economic growth and employment creation instead of being foregone as a macropolicy tool.

This four-by-four policy (4x4) assignment matrix in chart 3 is made possible by using fiscal policy for internal stabilization instead of the exchange rate, by exploiting the fact that fiscal discipline has important spillover effects on exchange rate stability, and by avoiding the extremes of entirely open capital accounts or fixed exchange rates. Selective capital controls can be assigned to the capital account whereas fully open capital accounts deprive policy makers from using capital controls as a tool of macropolicy. The number of policy tools is equal to the number of real and financial goals so that economic growth can be prioritized (chart 3).

Chart 3

ASSIGNMENT OF POLICY TOOLS TO POLICY GOALS UNDER INTERMEDIATE EXCHANGE RATE REGIMES (X)

	Price stability	Current account balance	Capital account balance	Economic growth
Fiscal policy	X+			
Exchange rate +		X		
Capital controls			X	
Monetary policy				X

Note: In intermediate exchange rate regimes (soft pegs and managed floating), the interest rate is delinked from the exchange rate, freeing up monetary policy for assignment to economic growth. Selective capital controls become the fourth policy instrument and are assigned to the capital account. Fiscal policy-based stabilization becomes the foundation for internal price and the exchange rate (+) stability, which gives more room for monetary policy to stimulate growth.

There are three ways, then, that these moves provide more policy space for monetary policy, specifically. *First*, fiscal policy-based stabilization has positive spillover effects on the exchange rate by providing a credible foundation for its stability. There is less need for high interest rates to strengthen an exchange rate already perceived to be strong by virtue of fiscal policy discipline under girding it. *Second*, capital controls assigned to the capital account allow the domestic interest rate to differ somewhat from the world interest rate without such drastic consequences as under the assumption of perfect capital mobility and open capital accounts. *Third*, selective exchange rate intervention loosens the automatic necessity of foreign exchange sales or purchases required under fixed exchange rates with direct consequences for the interest rate. Intermediate exchange rate regimes with fiscal policy-based stabilization can rely on a stronger exchange rate less affected by expansionary monetary policy than would have been the case with both monetary and fiscal policy assigned to growth, which could weaken the credibility of the exchange rate over time threatening its stability.

This set of goals and assignments contrasts with the deflationary bias of floating rate regimes and with the constraints imposed by fixed rate regimes which leave fiscal policy bearing all the burden for internal and external balance. *This combination of selective pragmatism in exchange rate and capital account management creates enough policy instruments for the number of policy objectives and provides the enhanced policy space essential for prioritizing economic growth in national economic policy. Fiscal policy-based stabilization frees up the interest rate from its rigid link to the exchange rate by directly and indirectly strengthening the real exchange rate.* This configuration has the advantage that monetary policy is an agile instrument for promoting economic growth due to the fact that it can be controlled more directly, immediately and flexibly than fiscal policy.

A problem with policy assignment scenarios is that spillover effects do, of course, occur. The effects of the use of the policy variable do not stay contained within the cell of the matrix the assignment designates, to be sure. The effects of fiscal discipline does dampen growth which monetary policy is trying to stimulate; monetary expansion lowering interest rates does weaken the exchange rate which tight fiscal policy is trying to strengthen. The assignment is not univalent, only affecting the desired outcome variable. This is a complication in all economic policy. The challenge is to manage with the policy space available the tensions and trade-offs embedded in each specific context.

VI. The exchange rate debate and policy space

The issue of policy space is tightly linked to the debate surrounding exchange rate regimes on which there is a variety of views. In back-to-back articles from the American Economic Association annual meeting in 2000, there are two diametrically opposite prognostications. Chang and Velasco write: “The question for most emerging market economies is no longer ‘To float or not to float?’ but ‘How to Float?’” (Chang and Velasco, 2000: 71). By contrast Reinhart writes: “If ‘fear of floating’ continues to be the serious policy issue it has been in the past, and if ... lack of credibility remains a serious obstacle, then the only way to avoid the ‘floating and credibility problems’ simultaneously may be full

dollarization. A corner solution indeed!” (Reinhart, 2000: 70). A year later, Dornbusch wrote: “Five arguments make up the case against currency-board arrangement ... On the surface each argument is persuasive; on closer scrutiny none really is” (Dornbusch, 2001: 238–239). Fischer concluded after a survey of trends in exchange rate regimes in the 1990s, “there is clearly a trend ... in the direction of hard pegged exchange rate regimes” (Fischer, 2001: 18).

These representative articles give a flavour of what Fischer called the “bipolar view” that the real choices are between floating and fixed and that there is what John Williamson has called “the missing middle”. If these views are correct, then the possibility of moving toward selective intervention in currency markets through “soft” pegged exchange rates or dirty floats with off-setting monetary actions would jeopardize the argument that policy space can be realistically enhanced by implementing alternative intermediate exchange rate regimes between the corners.

From the point of view of the line of reasoning presented here, a managed float exchange rate regime where there is central bank intervention in money markets for exchange rate management purposes constitutes a move away from the boundary lines of the trilemma and a factor in enlarging the policy space within the original triangle. Ninety one countries or just under 50 per cent of the 185 countries surveyed by Fischer (2001) at the end of 1999 had intermediate exchange rate regimes (managed floats or soft pegs) while 19 per cent had hard pegs, 5 per cent have joined currency unions (the EU) and 27 per cent had independent float regimes (see table 1).⁵

As a consequence, there were nearly as many countries at the end of 1999 that had intermediate exchange rate regimes which would potentially enhance policy alternatives through enlarged macro-policy space as there were countries with fixed or floating rate regimes with reduced policy discretion. As Frankel has put it recently, a more nuanced interpretation of current policy dilemmas would be to realize that the trilemma does not have to require that “one give up both *complete* stability and *complete* independence” and that it is possible to have “*half*-stability and *half*-independence in monetary policy” (Frankel, 2003: 17, italics added). There is room for policy choice when the purity of the corners is abandoned and pragmatic policy decisions substitute for options pushed by market fundamentalism.

Table 1 *Exchange Arrangements and Exchange Restrictions*

TYPE OF EXCHANGE RATE REGIME APPLIED IN DIFFERENT CATEGORIES OF COUNTRIES	<i>Exchange Arrangements and Exchange Restrictions (AREAER)</i>			Total
	<i>Hard peg</i>	<i>Inter-mediate</i>	<i>Floating</i>	
Developed countries	11	3	8	22
Emerging market economies	3	17	13	33
All other countries	31	71	28	130
Total	45	91	49	185

Source: Fischer (2001), figures 1, 2 and 3; and tables 1, 2 and 3.

Note: There were 28 countries with managed float regimes at the end of 1999, which together with 63 countries with “intermediate” exchange rate regimes (“soft” pegs of some sort) constitute a group of 91 countries out of a total of 185 countries. Within the framework being developed in this paper, managed float regimes are “intermediate” regimes rather than in the same category as “independent float” regimes, as in Fischer (2001).

(AREAER). In 1997 a new system was developed which contained a dozen categories, increasing to 13 in 1998.⁶ From 1997 to 2003, the IMF published summary tables showing the use by national governments of capital controls in each of these categories for all members of the IMF (see summary in table 2).

The patterns are clear.⁷ First, a substantial number of countries utilize a variety of capital controls. In 1996 over 100 countries registered themselves as using capital controls in seven of the 13 categories. Hence, capital controls were in wide use *before* the Asia crisis. Second, there was a significant increase in capital controls from 1996 to 1997, principally in two categories: financial credits and provisions specific to commercial banks and other credit institutions. This reflects the immediate response of countries *during* the Asia crisis. Looking at the 1996–2002 period as a whole *after* the Asia crisis, there were two types of trends. First, by 2002 there was an increase in the use of capital controls in additional categories, especially controls on personal capital movements and institutional investors. Second, there was virtually no increase or a slight decline in the use of capital controls in eight of the 13 categories between 1996 and 2002. *These two trends together show the selective targeted nature of the use of capital controls in contrast to an across-the-board approach in the wake of the Asia crisis.*

VII. Selective use of capital controls

Another example of this pragmatic approach is in the arena of capital controls. Given the number of different types of capital transactions, there is no particular reason beyond ideological ones why it would necessarily behoove a country to adopt the same policy for all types of capital transactions. Rather, there are alternatives for differential treatment for capital inflows as opposed to capital outflows, for short-term versus long-term capital, for portfolio flows vis-à-vis direct foreign investment, etc. The approach of selective intervention applied to capital controls achieves a similar result as that of selective intervention in foreign exchange markets in moving policy decisions out of the corners of extreme measures and off the boundary lines of the trilemma triangle.

The use of capital controls by national governments is widespread. Until 1997 the IMF had only one line for capital controls in its *Annual Report on*

Based on these patterns, it can be seen that there is already widespread use of capital controls by national governments. By 2002, over 90 countries used capital controls in each of 11 of the 13 categories. Whereas there was a significant increase in use in 1997 during the Asia crisis, it was not an avalanche. There was not a sea-change in the use of capital controls in 1997–1998 or beyond, for that matter. But there has been a steady increase in the use of six types of capital controls, including real estate and guarantees, from 1996 through 2002. This suggests greater eclecticism and pragmatism in economic policy-making since the Asia crisis.

The other important trend is that whatever tendency there was toward capital account liberalization before the Asia crisis, it seems to have come to a halt after it. Increased selective management of capital controls since 1996 seems to be an economic policy reality, just as the increase in intermediate exchange rate regimes in the 1990s has become evident as well. *These two moves away from the*

Table 2

USE OF CAPITAL CONTROLS: 1996–2002

(Number of provisions)

<i>Capital transactions</i>	1996	1997	1998	1999	2000	2001	2002
Controls on:							
Capital market securities	128	127	133	125	128	131	128
Money market instruments	112	111	115	110	111	110	107
Collective investment securities	107	102	103	103	102	101	99
Derivatives and other instruments	78	82	87	83	84	83	83
Commercial credits	103	110	105	108	109	107	104
Financial credits	76	114	112	113	114	113	112
Guarantees, sureties and financial backup facilities	82	88	88	93	97	96	92
Direct investment	144	143	149	147	146	147	149
Liquidation of direct investment	54	54	52	54	57	59	57
Real estate transactions	119	128	134	136	138	135	137
Personal capital movements	n.a.	64	82	90	93	91	97
Provisions specific to:							
Commercial banks and other credit institutions	131	152	155	158	157	157	160
Institutional investors	60	68	82	83	84	86	91

Source: International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions*, annual issues, 1997 through 2003. These reports are for the IMF financial year which ends on 30 April of the year of the *Report*. This is important since in 1997 countries reported before the Asia financial crisis that hit in mid-year. Individual countries report at different points in the year, but basically the Report reflects conditions in the previous calendar year.

extremes relieve the need to forego policy instruments and options for the sake of corner solutions and help create an expanded policy space in which policy makers can prioritize economic growth and combine policies to achieve multiple financial and real economy policy objectives simultaneously.

The selective use of capital controls in large emerging market economies is beneficial as a means of dampening exchange rate volatility but at the same time is hard to impose in a world of highly inte-

grated capital markets. Selective use of capital controls may still be feasible in these large middle income countries which now constitute important players in the global economy *providing that* monetary and fiscal policy discipline are sufficient to persuade markets that they are on a sustainable policy path. Selective capital controls and exchange rate intervention are even more feasible in smaller middle and lower middle income countries where there is less pressure from global financial markets than is the case in large emerging market economies.

VIII. From populism to orthodoxy to heterodox policy packages

If it is the case, as is argued here, that conventional economic wisdom tends to favour financial stability before if not indeed over economic growth and that there is a deflationary bias in conventional economic policy thinking, then it is also the case that efforts to reverse this prioritization and introduce a pro-poor growth bias in macropolicy management have sometimes erred in the opposite direction. In fact, there has been a variety of experiments in recent years some of which have come to be called “the macroeconomics of populism” (Dornbusch and Edwards, eds., 1991). Others have had more orthodox stabilization programmes while still others have introduced novel measures of a heterodox nature. A brief review of these experiences can provide the basis for *adding policy instruments* to the 4x4 policy matrix as another means of enhancing macroeconomic policy space (Agenor and Montiel, 1996: 265–297).

The two experiments in macroeconomic populism often cited are the Allende regime in Chile from 1971 to 1973 and the Garcia Government in Peru from 1986 to 1990. In both cases, there were direct interventions to increase wages on the one hand and control prices on the other with the hope that the real wage for workers would increase squeezing profit rates but increasing total profits. Interestingly, both governments moved off managed exchange rate regimes to fixed exchange rates as a means of controlling inflation but also to keep external debt payments a lower share of GDP. With budget deficits increasing substantially in both countries, inflation exploded undermining the exchange rate, ultimately causing a haemorrhage in capital outflows depleting foreign exchange reserves.

In Chile the fiscal deficit went from 3 per cent of GDP in 1970 to 25 per cent in 1973, while in Peru the public sector deficit went from 3 per cent in 1985 to 7.5 per cent in 1988. GDP growth surged in the early years of both governments to 9 per cent in Chile in 1971 and to 8.5 to 9 per cent in Peru in 1986–1987 only to plummet in both countries to -5.6 per cent in 1973 in Chile and to -8 and -11 per cent in Peru in 1988 and 1989. Inflation in both countries soared from 35 per cent per year in 1970–1971 in Chile to over 600 per cent in 1973 and from 63 per cent in Peru in 1986 to over 2700 per cent in 1989 (Agenor and Montiel, 1996: tables 8.2 and 8.3; and text pages

267–270). Both efforts ended in collapse with Allende being overthrown by Pinochet in 1973 and Garcia losing in an election to Fujimori in 1989. *The policy problem in these Governments was one of essentially sacrificing the goals of internal price stability and external balance for the goal of growth only to have the financial disequilibrium generated by this policy mix explode destroying the short-term real economy gains.* The forcing hand of external imbalance manifested itself in these two populist experiments undermining the internal agenda and the government itself.

It appears to be that in cases of macroeconomic populism “in the end, foreign exchange constraints and extreme inflation forced a program of violent real wage cuts that ended, in many instances, in massive political instability, coups, and violence” (Dornbusch and Edwards, eds., 1991: 8). Nevertheless, it also appears to be the case that *orthodox stabilization programmes involving major macro-policy adjustments end up restoring price stability and the balance of payments at the expense of GDP growth, real wage levels and employment.* The cases cited in Agenor and Montiel (1996) are Chile under Pinochet from 1974 to 1977 and Bolivian reforms in 1985. Fiscal adjustment was the centrepiece of these two reform efforts. In Chile the fiscal deficit declined from 25 per cent of GDP in 1973 to 2.6 per cent in 1975. The exchange rate was assigned to the current account rather than to price stability and was devalued at a rate greater than the inflation rate which improved the competitiveness of exports considerably. But success on the current account was not matched on the inflation front and furthermore GDP shrank by 14 per cent and unemployment mushroomed to 17 per cent in 1975. In Bolivia, a similar pattern emerged with draconian shifts from a fiscal deficit of 30 per cent of GDP in 1984 to a surplus of 3 per cent in 1986 with greater success than Chile in reducing inflation but with decidedly negative rates of GDP growth (Agenor and Montiel, 1996: tables 8.4 and 8.5; and text pages 270–275).

After a set of not overwhelmingly successful exchange rate-based stabilization programmes in Chile, Uruguay and Argentina initiated in 1978, *it was realized in the 1980s that in this sequence of experiences in Latin America none were able to achieve financial and real economy objectives simultaneously.* As a result, a number of still more innovative policy packages were undertaken in the mid-1980s in Argentina, Brazil, Israel and Mexico

Chart 4

**ILLUSTRATIVE ASSIGNMENT OF “NEW”
POLICY TOOLS TO POLICY GOALS AS A
MEANS OF PRIORITIZING ECONOMIC
GROWTH AS A GOAL OF
MACROPOLICY**

	<i>Current Price stability</i>	<i>Capital account balance</i>	<i>Capital account balance</i>	<i>Economic growth</i>
<i>Wage-price controls</i>	X			
<i>Trade liberalization</i>		X		
<i>Debt rescheduling</i>			X	
<i>Monetary and fiscal policy</i>				X

Note: The choice of the exchange rate regime in this scenario is delinked from the need for the exchange rate to be assigned to price stability as an exchange rate anchor, since it is assumed that monetary and fiscal policy discipline are sufficient to contain domestic inflation and undergird a stable exchange rate, regardless of exchange rate regime choice. This is a sine qua non of macropolicy. This context permits managed-float or soft-pegged type “intermediate” regimes to work to create more macropolicy space for a greater number of fiscal and monetary policy options to be potentially applied to the goal of economic growth. Selective use of capital controls, while helping improve the capital account, in this scenario also enhances the macropolicy space for the application of monetary and fiscal policy to growth objectives.

(Agenor and Montiel, 1996: 282–297). *These heterodox approaches yielded up several additional instruments of economic policy which help generate a greater amount of flexibility and combinations enhancing macropolicy choice.*

For example, debt reschedulings in the 1980s became an additional instrument for achieving capital account balance, while trade liberalization became a tool for achieving improvements in the trade or current account balance. Privatization of public enterprises became a way of temporarily improving the public sector deficit and capital inflows at the same time. The problem was that privatization was not a continuous source of additional finance but a temporary one. Wage and price controls (“pactos”) were increasingly applied as a way of trying to increase real wages while containing inflation. New currencies were created as a way of gaining a fresh start and innovative exchange rate management modalities were experimented with as ways of steering between fixed and flexible exchange rates. The new policy instruments – wage and price controls, trade liberalization and debt rescheduling – can be assigned within the traditional 3x3 matrix to the goals of price stability, the current account and the capital account, respectively (chart 4).

This new assignment frees up monetary and fiscal policy to have greater room to promote growth, employment and poverty reduction, while maintaining sufficient discipline to further contribute to containing inflation and to exchange rate stability, against the background of a stable financial context strengthened by these new measures. See 4x4 assignment matrix above. *The prioritization of real economy objectives is more feasible in contexts in which policy instruments are being added to the mix than in ones in which they are being foregone.* And the possibilities for coming up with a variety of possible policy packages to promote real economy goals increase as the number of policy tools increases. As a consequence, these heterodox policy experiments and experiences have made important contributions to enhancing the degree to which monetary and fiscal policy can be assigned to economic growth while increasing policy flexibility and choice. Another source of new policy perspectives has been the dynamic growth of the East Asian economies since the 1970s and their rapid recovery from the Asian financial crisis in the late 1990s.

IX. The East Asian experience: strategic frameworks for macropolicy

Today, Latin America and East Asia again seem to be juxtaposed in the minds of many as examples of failure and success, similar to the great debate over the reasons for the success of the “East Asian Miracles” in the 1980s and 1990s. Now, Latin America is looking back on a period of twenty years of economic policy reform and re-democratization and finding the economic and social benefits of these reforms to be wanting. Economic growth has been slower than anticipated; unemployment continues to be high; and poverty reduction has not improved at the rate hoped for. Several studies have concluded that the reforms associated with the market liberalizing agenda of the Washington Consensus have not led to sufficient economic growth nor to accelerated social improvement (Ocampo, 2003; and Correa, 2000). There have been several efforts by Latin Americans and others to rethink development strategies for Latin America to break the stall in progress perceived to plague the region to this point (Kuczynski and Williamson, eds., 2003; and Bradford Jr., 2004).

By contrast, East Asia seems to have rebounded from the Asia financial crisis in the late 1990s and be regaining the growth momentum that had distinguished its performance over the last three decades. In this context, recalling how Latin America and East Asia were presented as studies in contrast in the 1980s and early 1990s, it seems appropriate to inquire regarding the lessons that might be drawn from the dynamic growth experience of East Asia that might inform an effort to reformulate strategic thinking in the rest of the developing world.

The debate regarding the East Asian success stories was one in which two stylized dichotomies were pitched against each other. Latin America was seen as undertaking inward-looking, price distorting, interventionist, policies which made their economies inefficient and slow growing. East Asia was seen as implementing outward-oriented, liberalizing, market-driven, export-led growth strategies. These contrasting features were meant to explain the differences between the two regions in terms of failure and success.

Given this way the debate was structured, the conventional wisdom tended to see macropolicies as subservient to the exigencies of market liberalization, especially trade liberalization. This meant that

the role of macropolicy was to maintain tight monetary and fiscal discipline to keep inflation down to enhance the country’s competitiveness as it sought to create an export-led growth path based on openness to the world economy, domestic prices equalling world prices, and a real exchange rate that would not be over-valued. These in essence constituted what came to be in 1989 the Washington Consensus. The export-led growth strategy, from the mainstream point of view, was based on the idea that growth would be driven by external demand inducing export growth in countries with open economies and sound macropolicies. Macropolicies had a secondary role in this formulation aimed primarily at achieving price stability which in the context of a trade liberalization effort would presumably make the economy competitive and lead to growth through exports. Economic growth followed from financial stability rather than from a development strategy or a macropolicy that gave priority to growth. Rather, the priority was on economic integration with global markets which would force an alignment of domestic prices with world prices achieving competitiveness. The force field, from this perspective, was from outside inward.

Another way of seeing the same phenomenon viewed the process as working from inside outward. From this alternative perspective, deliberate development strategies were designed to accelerate growth through high investment-GDP shares channelled by market forces and government guidance to high productivity sectors (Rodrik, 1997, 1999; Bradford Jr. and Chakwin, 1993; UNCTAD, 2002: 51–85; and UNCTAD, 2003: 57–89). These sectors had the potential to claim market share in world markets based on a combination of actions, factors and policies which made those sectors highly competitive. The net result of this formulation was that the East Asian success stories were seen as export-push rather than as export-led regimes. *The high performance of East Asia was attributed to growth-led exports, with dynamic economic growth generating supply-driven exports, rather than to export-led growth which derived from openness to world demand* (Bradford Jr., 1994). The clincher in terms of evidence in this debate seemed to be that East Asian export growth for twenty years was several times the average growth rate in world demand for exports which gives more credence to the export-push notion of insertion into world markets claiming market share over the openness to world markets, demand induced export-led growth idea.

This rather extensive and extended debate over East Asia does seem to leave the legacy of an active role for policy in the process of accelerating economic growth. It seems clear now in retrospect that the stylized versions of East Asian success made choices as between the market and the state, the public or the private sector, hands-on or hands off strategies unnecessarily dichotomous alternatives. The East Asian success stories seemed to have had variety in their content. The Republic of Korea had a private sector driven by large corporations whereas small and medium enterprises were dominant in Taiwan Province of China. Hong Kong (China) was close to a *laissez faire* regime whereas Singapore was characterized by a highly authoritarian and dirigiste hand of government in the economy. There really was no single economic model in East Asia.

Equally important the relationship between the public and the private sector appears have been catalytic, more in the nature of loose coordination and even cooperation than coercive, directive or dichotomous. Public policies were meant to follow the market rather than replace it, enhance competitiveness rather than protect against it or subsidize it, and create an enabling environment in which private enterprise could not only be efficient but also dynamic. These strategic characteristics of public-private sector relations facilitated an exceptional performance in both economic growth and exports.

Macropolicy in East Asia was a part of the development strategies of the region which were steadfastly dedicated to dynamic growth, rapid structural change internally, and high export performance. Monetary and fiscal discipline were maintained; external debt levels were not large as a percentage of the fast-growing GDP; and exchange rates did not become overvalued. Macropolicy was agile, highly responsive to shifts in the external context, rather than locked into a policy path. *But the clear priority was on growth; financial stability was subordinate to the primacy of dynamism.*

A key aspect seems to have been the connection between macropolicy and structural policy in which the links between sectoral policies, trade and macroeconomic growth contributed significantly to economic dynamism. Heckscher-Ohlin theory of trade suggests that there is a ladder of comparative advantage in which countries find themselves moving from natural-resource based production (agriculture and mining) to labour intensive manu-

facturing, to capital intensive manufacturing to human capital intensive production, and services to technology intensive industries. This ladder represents ascending rates of productivity growth as countries move up the ladder. Shifts in the sectoral composition of output drive rates of structural change. Empirical evidence suggests that countries with high export-GDP shares have high rates of structural change (Bradford Jr., 1994: table II, page 30 and pages 19–20). As countries grow fast their workers become both better paid and better educated which means that sectors requiring higher skilled labour tend to grow as capital accumulates and eventually replace sectors with lower skill requirements. These internal shifts in production patterns result in commensurate changes in the composition of trade. *The interaction of growth, structural change and trade is one of the principle dynamics that drive the high performance of the East Asian economies.*

It seems fair to say in retrospect that the leadership of the East Asian economies were more concerned about the competitiveness of their economies in the broadest sense than in the narrower issue of the appropriate level of their exchange rate. One might say they were more concerned about the real effective exchange rate of their economies than the value (real or nominal) of their exchange rate. This means that they were concerned about the institutional environment, the banking system, labour-management relations, the business culture and climate, rule of law and commercial codes as components of competitiveness along with sound macroeconomic policy conditions. *The East Asian view of dynamic economic growth was holistic and integrated not narrow and technical. Their economic policies were embedded in a broad strategic framework which was inclusive. Their view of competitiveness went beyond “getting prices right” and beyond getting policies right to a broad sweep of institutional, behavioural and regulatory norms. The strategic perspectives and choices were critical to their success.*

The East Asian experiences of highly dynamic growth provide examples of how economic policy can be integrated into a larger strategic framework which includes structural policies, institutional dimensions and a catalytic role for government in engaging, involving and facilitating private sector participation in the growth strategy. In the East Asian cases both the public and the private sector are complementary participants in enhancing national

competitiveness, accelerating economic growth and insertion into the world economy. Macroeconomic policy management was exemplary in East Asia but macropolicy management by itself does not explain the high economic performance. *The effectiveness of macropolicy in East Asia resulted from its being a part of a larger strategic framework that marshalled other dimensions and assets to achieve exceptional growth, generating higher yields from sound macropolicies.* The East Asian experience provides useful insights into how to take full advantage of enhanced macroeconomic policy choice to generate major impacts on economic growth, employment and poverty reduction.

X. Conclusions: the logic of enhanced macropolicy space and its implications

This paper has spelled out the logic for increasing policy space for the conduct of macroeconomic policy for the purpose of prioritizing real economy goals of growth, employment creation and poverty reduction. The logic has proceeded in several steps. First, *there is the need to create more policy instruments so that a greater number of policy goals can be addressed.* Frequently, real economy goals get crowded out by financial objectives in part because often there are too few instruments for too many goals. The heterodox policy experience of several developing countries has yielded additional arenas for policy action as well as more policy tools which help alleviate the crowding out problem.

Second, there is a need to avoid extreme all-or-nothing policy choices which have the effect of reducing the number of policy instruments available as well as the effect of assigning the remaining policy instruments to the more urgent goals. Financial and external crises tend to trump in this situation. Here *the calibrated use of policy tools by degrees of commitment, deployment and assignment can create space for mixes of policies.* This enhanced policy space yields a wider range for different combinations of policies which replace dichotomous choices between extreme “corner solutions” such as open versus closed capital accounts, fixed versus flexible exchange rate regimes, autonomous versus foregone monetary policy discretion, as embodied in the trilemma. *Selective capital controls, intermediate*

exchange rate regimes, and some monetary policy autonomy create the policy space within which a variety of policy combinations and mixes are possible and a greater number of instruments are available for assignment to policy goals. Prioritization of real economy goals becomes both more feasible and more likely with a broader range of policy alternatives.

Third, along with the selective use of capital controls, fiscal policy-based stabilization instead of exchange rate-based stabilization delinks the exchange rate from the goal of internal financial stability to which it is yoked in a fixed rate regime. This delinkage enables the use of intermediate exchange rate regimes (soft pegs and managed floats). The use of these regimes in “the missing middle” create policy space where different mixes are possible generating a greater range of policy alternatives. With fiscal policy assigned to internal balance, the exchange rate can be assigned to the current account and selective capital controls to the capital account. Under this configuration (see chart 3) monetary policy is loosened up from its rigid linkage to the exchange rate by fiscal discipline strengthening the exchange rate. With this combination of fiscal discipline, some capital controls and an intermediate exchange rate regime, monetary policy can then be assigned to economic growth. The degree to which monetary policy can be assigned to growth is buttressed by the degree to which the other macropolicy tools are used to achieve internal and external balance. Monetary policy has the advantage of an instrument for growth that is able to be flexibly managed.

Fourth, prioritizing real economy goals is also facilitated by the design of a larger strategic framework for accelerated development which includes institutions, norms, behaviours and governance. The larger strategic framework mobilizes more assets and power toward a dynamic growth trajectory which creates a more favourable context for macroeconomic policy. *The growth, employment and poverty reduction outcomes from macropolicy are likely to be larger when they are part of a wider effort to marshal resources for accelerated development.* The examples of the East Asian success stories provide the evidence for this conclusion.

These four steps in the logic for increased macroeconomic policy choice provide reasons to believe that there is indeed room for macropolicies for growth even in the face of considerable theoretical and experiential evidence that there can be strong

deflationary biases in macropolicy-making. These four innovations – new policy tools, selective pragmatism, fiscal policy-based stability, and strategic framework – reinforce each other in their capacity to create more policy space. To the extent that efforts are made on all four fronts simultaneously the greater the flexibility and choice open to publics and policy makers in forging macropolicies appropriate to national contexts and current circumstances. With a greater range of policy choice, economic policy would be able to *contribute to the strengthening of democratic process* by engaging public institutions and policy makers in open debate on alternative policy paths rather than isolating economic policy-making from public discussion due to the sense of lack of options.

Furthermore, enhanced policy space and alternatives would be expected to enrich and enliven the international debate about the policy prescriptions, conditionality and development strategies of the international financial institutions as they seek to support development. The broader array of policy alternatives might be expected to bring more diverse perspectives from different country experiences to the international discussion of policies of the international institutions. There is more reason to have stronger mechanisms for global economic governance and better representation from diverse countries if there are fresh viewpoints and a wider range of views on effective combinations of policies. *Therefore, the extent to which there can be greater degrees of choice in macropolicy-making is a key foundational idea for creating a more representative and a more meaningful system of global economic governance.*

Nonetheless, it should be emphasized that the feasible enhancement of macropolicy choice strengthens national policy as the primary nexus for decisions on national priorities and on the trade-off between economic growth and stability. Against the background of the pattern of global imbalances rooted in domestic macropolicy imbalances over the last thirty years, national governments have a strengthened hand as the principal mediator between the global economy and national economies with increased policy space. The supposed erosion of national autonomy due to globalization encounters countervailing forces as *countries are able to suc-*

cessfully design pro-growth policy paths due to enhanced macroeconomic policy choice. National decision-making is still the locus of governance in economic policy, even in an era of globalization. The nation-state as the nexus point for macropolicy choice is another foundational idea of global economic governance.⁸

Notes

- 1 The equalization of returns in all markets in an integrated world economy composed of open economies follows the principle of interest parity which with capital mobility requires that the combination of interest rate differentials between two markets and the difference between their expected and actual nominal exchange rate must be equal. This means in effect that interest rate shifts in one market require an off-setting exchange rate adjustment, and conversely, an exchange rate shift originating in one market requires an offsetting monetary policy (interest rate) shift in the other market. Otherwise, differential returns between the two markets will lead to disproportionate flows out of one toward the other.
- 2 A similar argument is made in Frankel (2003, especially pages 17–19). I am indebted to Susan Collins for this reference.
- 3 The emphasis in this section on “rational pragmatism” and “the pragmatic middle” is in the same spirit as Bryant’s superb treatment of cross-border finance in his section on “A Middle Way: Steadfast Eclecticism” in chapter 12, pages 386–389, and elsewhere in Bryant (2003).
- 4 For an articulation of fiscal-based exchange rate stabilization, see Bradford Jr. (1999: 54–56). See also UNCTAD (2003, especially pages 137–138).
- 5 From Fischer (2001: figures 1, 2 and 3; and tables 1, 2 and 3), there are 28 countries with managed float regimes at the end of 1999 which together with 63 countries with “intermediate” exchange rate regimes (“soft” pegs of some sort) constitute a group of 91 countries out of a total of 186 countries. Within the framework being developed here, managed float regimes are “intermediate” regimes rather than in the same category with “independent float” regimes, as in Fischer (2001).
- 6 See especially section II, “Measures of Capital Account Restrictions”, Edison et al. (2002: 4–19).
- 7 International Monetary Fund (IMF), *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAR), annual issues 1997 through 2003. See “Summary Features” tables in each volume, and also the preface and introduction to the 1997 AREAR establishing the new tabular format.
- 8 Bryant (2003: 390–398) makes very similar points in his chapter on “The Evolution of International Financial Governance”.

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