Initiative *for* **Policy Dialogue**

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Introducing the Key Questions

Few things matter more to society than economic growth and stability; yet few issues are more controversial. More than a decade after economic integration, Europeans are still debating the European Union's (EU's) stability pact and the European Central Bank's almost exclusive focus on avoiding inflation at the expense of employment. Is the EU approach the cornerstone of a successful stabilization policy, or are its institutional structures sentencing Europe to ongoing stagnation, if not recession? In the United States, some Republicans have become Keynesians, arguing that deficits will provide the stimulation that the economy needs. Meanwhile, some Democrats argue not only that the Bush administration's tax cuts have provided little stimulation in the short run but also that the resulting deficits will inhibit growth in the long run.

Economic growth and stability are of even greater concern in the developing world. In general, conservative economists have pursued a counterintuitive course in many developing countries. They've advised pro-cyclical, contractionary fiscal policy during downturns—just the opposite of the strategy regularly adopted by governments in the developed world, and just the opposite of what students of macroeconomics learn.[1] For example, in response to crises in Argentina, Korea, Thailand, and Indonesia, during which there were clear signs of severe economic downturns, the International Monetary Fund (IMF) advocated contractionary fiscal and monetary policies. This is an ironic twist of history, as the IMF was created under the intellectual aegis of John Maynard Keynes who ardently advocated the use of counter-cyclical fiscal policies—increasing expenditures and cutting taxes to stimulate the economy during downturns.[2]

According to its critics, the contractionary policies advocated by the Fund made the downturns worse. Even the IMF now agrees that it erred in

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the case of the East Asian countries.[3] A study produced by its Independent Evaluation Office[4] reported that the IMF consistently overestimated growth and investment prospects, even in countries not in crisis. This inevitably led it to advocate for excessively austere fiscal and monetary policies.

More generally, conservative policies pushed in the 1990s emphasized price stability, liberalization, and privatization. Critics have argued that these policies were misguided and have pointed out that, in the long run, these policies have impeded growth. Instead of focusing exclusively on fighting inflation, they argue that policy-makers should focus on real economic stability, and long-term sustainable, equitable growth; with a balanced emphasis on growth, employment, and inflation.

In addition, the critics argue that conservative economists have largely ignored the relationship between structural reforms and macro-stability. Some of the structural reforms pushed during the 1990s, such as reforms that encouraged countries to live within their means, have had positive impacts. But other central reforms, such as capital and financial market liberalization,[5] have exposed developing countries to external shocks, and also reduced their capacity to respond to them. In addition, some reforms like privatization were implemented without the proper institutional framework in place, resulting in inefficient allocations of resources (due for example, to unbridled monopoly power) and widespread corruption (so much so that privatizations in many countries were nicknamed 'briberizations').

Although most economists now agree that institutions matter, international advisers have not had much to say on how such institutions should be created, and economists differ on what is meant by 'good institutions'. For example, debates exist on the role of the central bank, the structure of financial regulations, and bankruptcy laws. All of the debates have major implications on stability and growth,[6] as we'll discuss in this book. In addition, the link between policies and institutions is still not adequately recognized. Not only are good institutions necessary for stability, but instability can affect the development of good institutions. For instance, high interest rate policies in Russia (and the failure to create viable financial institutions to supply credit to new and expanding enterprises) made asset stripping more attractive than wealth creation, and weakened support for the creation of the kind of rule of law that would have supported capital accumulation.

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As evidenced above, economists differ greatly in their views and policy prescriptions. All economic policies, though, have trade-offs. Policy choices come with risks, and the risks involve different beneficiaries and victims. Who makes the decisions also matters. Political processes play a key role in macroeconomic policy just as they do in most arenas of economic decision-making. If there were no alternative policies, or if one approach were best for everyone, then we could leave the design of economic policy to domestic and international technocrats and bureaucrats. But there are always alternatives and trade-offs. Choices are political in nature and cannot be left to technocrats.

The role of the economic adviser (in foreign or domestic policy) should be to identify the trade-offs and explain and (where possible) quantify the risks. The international financial institutions have sometimes failed to do this in their role as adviser to developing countries. Even if their policies achieved what they promised, they could still be criticized for putting certain concerns above others. In addition, the process by which these institutions have pushed their policies has sometimes undermined democracy by not allowing the political process to determine what weight to attach to the different objectives and risks.

In situations of uncertainty, good decisions *ex ante* (based on the best information available at the time) often turn out to be wrong *ex post*. Sometimes the opposite of what's expected happens. But policy-makers should not be blamed for the former or given credit for the latter. What policy-makers and their advisers should be held responsible for is whether *ex ante* they correctly assessed the trade-offs and the impact of the alternative policies (including the risks to employment and growth). They should be criticized if they pretended that there was only a single 'correct policy', a policy that Pareto dominated[7] all others.

Advisers, in particular, bear a special responsibility not to advocate policies that reflect their own objectives under the guise that they advocate the single best policy. Their job is to convey the range of alternatives, their assessment of the consequences of alternative policies, and a fair and accurate portrayal of the uncertainties—especially in the areas where there is active debate among economists (e.g. about how best to stimulate the economy). The widespread concern is that the advice of conservative economists is too often based on models that lead to excessively contractionary fiscal and monetary policies. As noted above, they put too much emphasis on inflation, and too little on growth, unemployment, and the impact on the poor.

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Much of the advice given to developing countries has failed to identify these alternatives and provide countries with advice about the trade-offs. Moreover policy designers have failed to consider the marked differences not only between developing and developed countries, but also among developing countries and within regions (such as differences between East Asia and Latin America). The one-size-fits-all advice has been insensitive to these differences.[8]

For example, constraints are more binding on some countries than on others. Countries with smaller domestic capital markets and a limited ability to borrow abroad are less able to use counter-cyclical fiscal policies. Wage and price volatility might be higher in general in the developing world, but some regions have much greater volatility than others.

Similarly, financial markets, which play an important role in many economic crises, are far more developed in some regions than in others. Securities markets, which are essential for risk sharing, provide only a limited source of finance for new investment in the most advanced industrial countries,[9] but are particularly weak in most developing countries. In more developed countries, the role of banks in finance has diminished. This has increased concern about the efficacy of monetary policy, which focuses on banks as a source of credit.[10] In most developing countries, however, banks remain the most important source of finance, but in some of the poorest countries, money and credit play a far less significant role; in these countries (as in the most advanced countries), monetary policy often has limited scope.

Open capital markets often impose further constraints on monetary and fiscal policies. The conduct of monetary policy is largely dependent on the extent to which capital markets are liberalized. With open capital markets, attempts to stimulate the economy by lowering interest rates or increasing government deficits provoke capital outflows, weakening rather than strengthening the economy.

As a result of these differences, developing countries experience more economic volatility than developed countries (in part, because developing countries often have less diversified economies), so attention to stabilization is particularly relevant. In this book, we take a broad perspective on stabilization policy. We include day-to-day management of the economy, responses to crises, and policies (including structural reforms) that affect economic stability.

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Day-to-day economic management includes how much emphasis to put on using monetary policy to control inflation, how aggressively monetary authorities should respond to the first signs of inflation, what kinds of tax cuts or expenditure increases best stimulate an economy when it's in a recession, and whether policy-makers should use a wide range of *microeconomic instruments* to manage the macro-economy. Responses to crises include whether or not to focus on reducing the deficits that typically arise when an economy goes into crisis, whether raising interest rates significantly is an appropriate response, and whether governments should use alternative instruments, such as capital controls or other capital account regulations.

The objective of this book is to show that there are alternatives, both for day-to-day macro-management of the economy, and for responding to crises. For instance, in September 1998, Malaysia reacted to the East Asia crisis by instituting capital controls while Thailand did not. Malaysia's downturn was shorter and shallower—and it emerged from the crisis with less of a legacy of debt. While there are a multitude of differences between the two countries, we would argue that at least part of Malaysia's superior performance is related to the fact that it imposed capital controls and did not follow orthodox prescriptions.[11] During the crisis, China implemented standard Keynesian policies and not only avoided a downturn, but also sustained its rapid economic growth. China's experience demonstrates the possibility of complementarities. When exports and growth were threatened, investments were increased. China's policy not only promoted higher incomes in the present, but also promoted higher income for the future. Similarly, India's prudence with capital market liberalization not only sheltered it from contagion in the financial crisis but also enabled it to follow macroeconomic policies that sustained rapid economic growth.[12]

The above discussion highlights the importance of integrating macroeconomic management and capital market liberalization. We have therefore divided this book into three parts. The first part is a general overview, the second part focuses on issues in macroeconomics, and the third part lays out the debates on capital market liberalization.

In the next chapter we'll discuss one of the most fundamental (but often poorly articulated) questions: what are the objectives of macroeconomic policy? Many of the differences in policy stances arise because analysts have differing views about objectives. For example, for most people, controlling

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inflation is a means to achieve faster, more stable, and more equitable growth. But sometimes economists and policy-makers turn price stability into an end in itself, and this jeopardizes more fundamental objectives, such as increasing growth and reducing poverty.

In addition to having different objectives, economists often disagree about how an economy functions and often operate using different assumptions. One of the great advances of modern economics is that analysts strive to develop formal and quantitative models that can be used to forecast the evolution of an economy. The precision that models give does help economists identify the critical differences in their assumptions and why they differ in their assessment of the consequences of a policy. Once this is accomplished, it becomes possible to consider which of the assumptions are reasonable and which are not. If the assumptions of the models don't make sense, then the conclusions derived from the models won't make sense either. In the second part of Chapter 2, we take a look at the assumptions that have given rise to some of the most important policy differences.

In Part II, we look at the current debates in macroeconomics in more detail. In Chapter 3, we take a closer look at alternative policy positions, to understand why economists have such different prescriptions for the same events. We approach this complex subject using three prototypical policy perspectives: the conventional Keynesian perspective, the conservative perspective, and a third perspective that attempts to integrate several alternative approaches. We call this third approach 'the heterodox perspective', although we use this with caution since economists use this term in a variety of ways.

Chapter 4 examines the differences in macroeconomic policy between developing and developed countries. The basic macroeconomic identities and aggregates, such as growth, inflation, and unemployment, of course, remain the same. But the institutional setting, including the level of development, gives rise to large variation in economic outcomes and policy choices.

In the following chapters we use the framework set up in Chapters 3 and 4 to examine the main policy instruments from the three alternative perspectives. Chapter 5 looks at monetary and fiscal policy in a closed economy. Chapter 6 extends the analysis to an open economy. In this chapter, we introduce exchange rate policy and analyze the complex relationships between exchange rate, fiscal, and monetary policies as well as the ways in which capital flows complicate traditional analyses. Chapter 7

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then looks at exchange rate management and other policy options for an open economy.

Chapter 8 deals with three key issues that affect all policy perspectives. The first is the accounting framework of economic policy; this is the lens used to ascertain whether an economy is likely to overheat or to slip into recession. We find that widely used accounting frameworks often provide misleading information and bear some responsibility for poor economic advice and performance. Chapter 8 next considers the issue of risk, and how understanding and managing risk is crucial for policy-making. Reforms can modify both the vulnerability of an economy to shocks and its ability to respond to these shocks. Ideally, stabilization policy should do more than steady an economy sinking into recession or facing a crisis; it should create an economy less prone to these problems to begin with. Economists have paid remarkably little attention to this basic issue. The final section of this chapter looks at an aspect of policy to which economists have increasingly become sensitive: the institutional frameworks within which policy decisions are made. Chapter 9 then revisits some of the key issues of economic stabilization. In this chapter, we examine how different positions among economists arise from the different assumptions they make and the different models they use.

We then move onto the issue of capital market liberalization in Part III. Capital market liberalization (CML) has been one of the most important sources of macroeconomic instability facing countries in the developing world. The IMF and other international institutions pushed for capital market liberalization throughout most of the 1990s, based on the expectation that it would reduce volatility. Although there is now general agreement that capital market liberalization has not led to growth and stability (but has led to instability), several important debates still remain. In Chapter 10, we look at the basic arguments for and against CML, and examine why capital market liberalization failed to live up to the expectations of its supporters. We continue this discussion in Chapter 11, with a more in-depth examination of the capital market failures that lead to greater risk. Capital market regulations are an important tool for policy-makers in developing countries, but economists don't agree on the most appropriate ways to regulate flows. We devote Chapter 12 to an analysis of the alternative modes of intervention. In Chapter 13, we examine some of the other outstanding debates on CML.

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One of the major differences between stabilization policy for developing and developed countries is that developing countries are more concerned with growth. Some economists worry that badly managed stabilization and liberalization policies will impede economic growth. In Chapter 14, we conclude by reviewing some of the key links between stabilization, liberalization, and growth.