Slide show: Macroeconomics

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Roles of macroeconomic policy

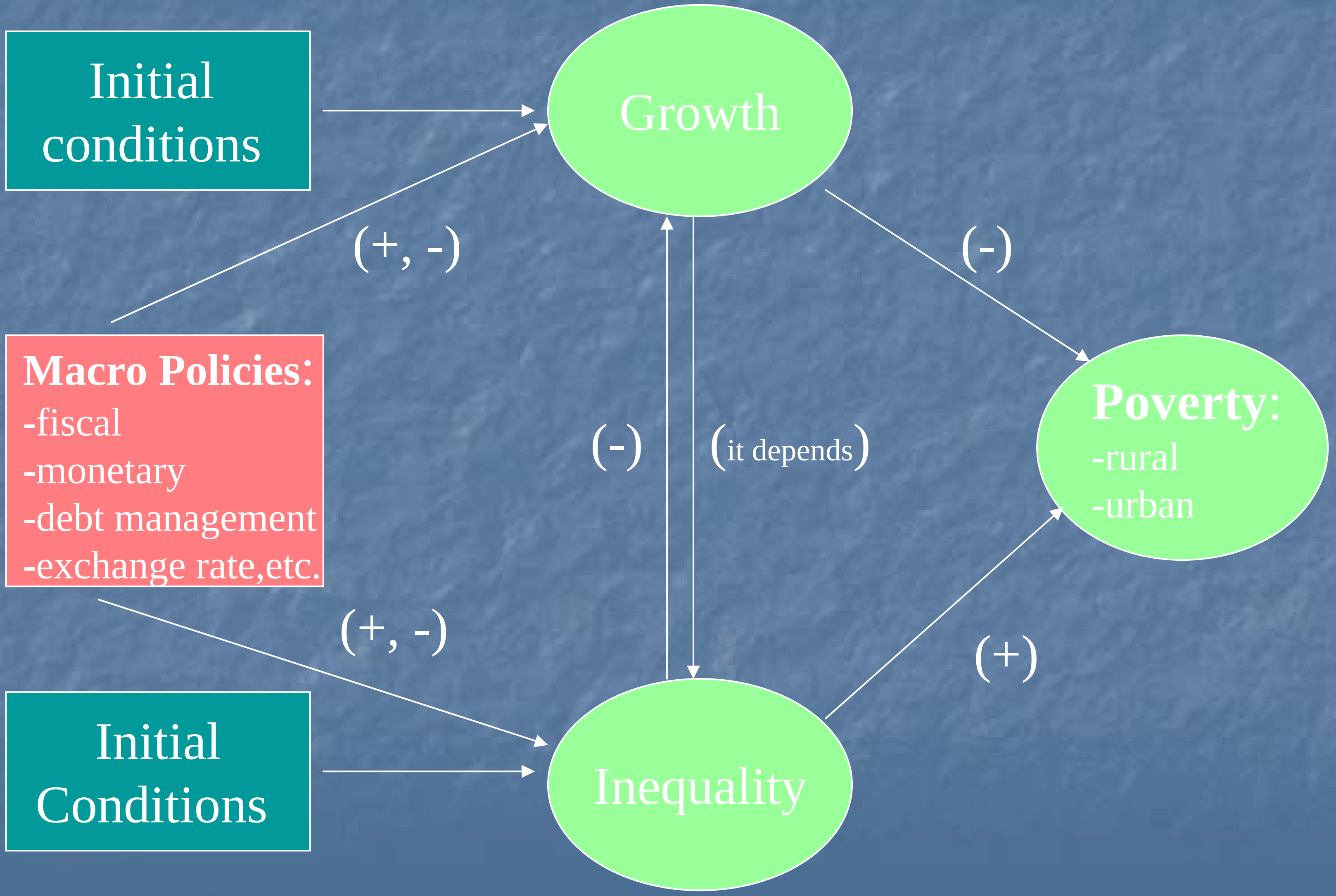
- Stabilize economy at lowest social costs when it is hit by ‘exogenous shocks’
- Contain its over-expansion during windfalls
- Stimulate aggregate demand when economy is weak and spare capacity exists
- Ensure the stability of the economic environment so as to stimulate growth and attract foreign investments

Macroeconomic policy and poverty

- Poverty is strongly influenced by <u>structural factors</u> (history, geography, factors endowment, etc.) and <u>social policy</u>

- But macro policies can make a huge difference:
  - Fiscal policy, size of the budget deficit, inflation
  - Taxation level, tax incidence, public goods, and work incentives
  - Public debt and sustainability
  - Monetary policy and inflation
  - Balance of Payments, reserves, and exchange rate
  - Exchange rate regime, distribution and competitiveness
  - Industrial policy and external openness
  - Pricing policies and internal terms of trade

Framework to assess impact of macroeconomic policies on poverty



Growth impacts poverty, but so does inequality

Poverty/Growth elasticities

(under different assumptions about Gini index [columns] and the ratio of PL to average income)

	0.3	0.4	0.5	0.6
0.33	-3.9	-2.1	-1.3	-0.8
0.50	-2.8	-1.6	-1.0	-0.7
0.66	-2.0	-1.2	-0.8	-0.5
1.00	-1.2	-0.8	-0.5	-0.4

High inequality affects growth and poverty

<u>Direct effect</u>. A 1% rise in GDP reduces poverty by:

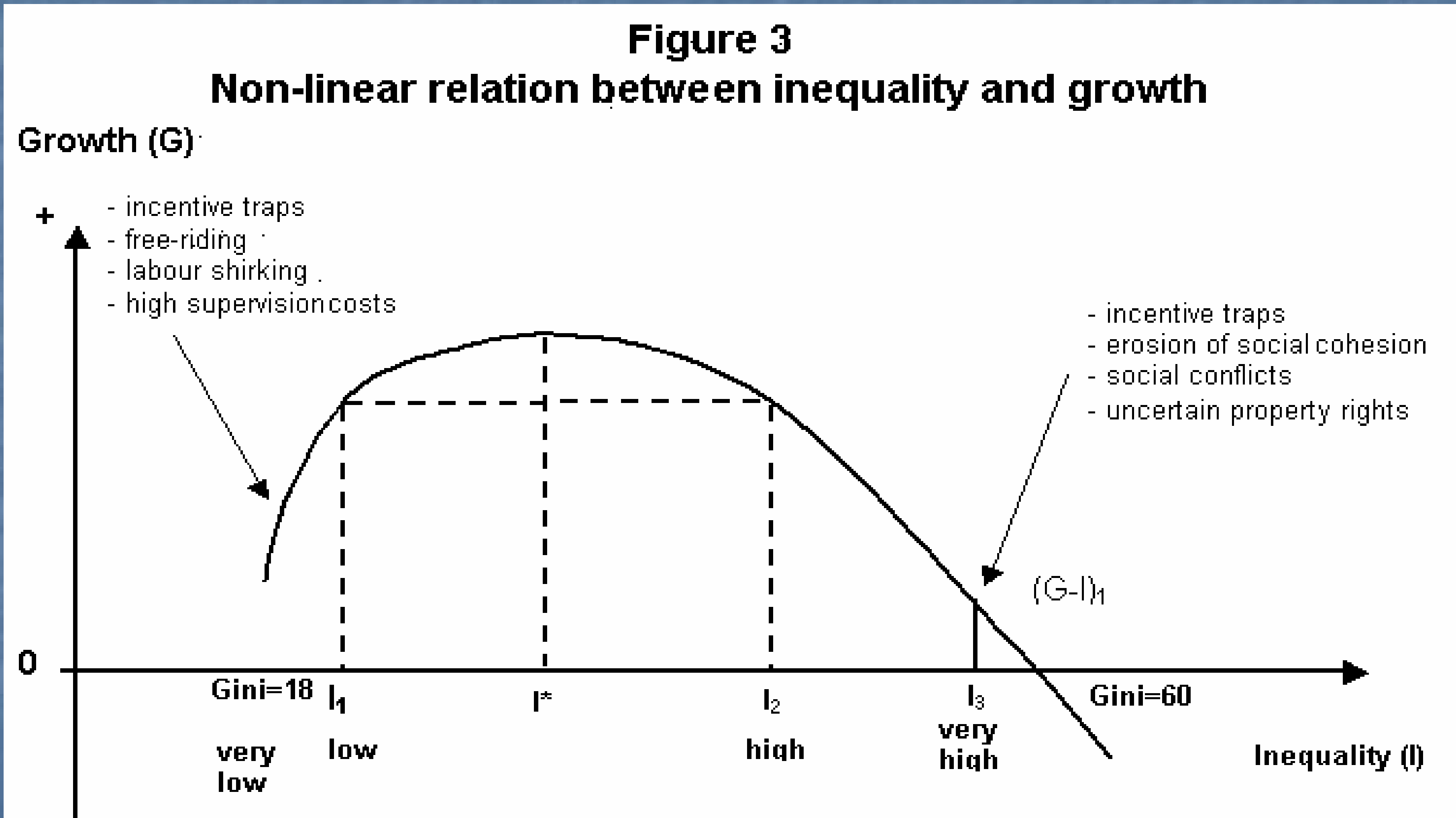
- 0.4-0.7% in countries with Gini 0.60 (see prior table)
- 2.0-3.9 in countries with Gini of 0.30

<u>Indirect effect</u>. With few exceptions, Ginis >0.4 reduce <u>also</u> medium term growth because of:

- Low investment in human capital (Perotti)
- Decreasing returns to capital (Aghion et. al.)
- Policy distortions, government failure (Alesina-Drazen, Birdsall)
- Erosion of work incentives (Venieris-Gupta)
- Macroeconomic and political instability
- Loss of cohesion & ability to undertake collective action

Thus, <u>moderate</u> <u>inequality</u> should be the policy target

Inequality → growth



Growth → inequality relation

There is no universal relation between higher GDP/c and inequality:

- Some theories (Kutnetz, Lewis) and countries (Viet Nam) show that growth raises inequality in first phases of development, then reduces it (when GDP/c > 6.000$)
- But many examples (S. Korea, Taiwan) point to stable or falling inequality with rising growth
- It all depends on the country's conditions and policies

Therefore, there are no trade-offs between equity and growth

Growth composition and poverty

- Growth matters a lot for poverty reduction
  but the composition of growth matters even more.

- Growth in sectors where the most poor are employed has a far bigger impact on poverty than growth in sectors where people are non-poor

Budget deficit and poverty

Large/persistent deficits may cause problems:

- Raise taxes – cut essential expenditure
- Issue of bonds → + int.rates → crowding out of private investment?
- Purchase of bonds by state banks (financial repression) → dis-intermediation
- Monetisation → after some point, seignorage → inflation

Moderate deficits are justified/sustainable if:

- Temporary and financed in non-inflationary way
- Are due to expenditure on key infrastructure
- If effected in counter-cyclical mode

Taxation and poverty

Taxation is required to provide public and merit goods and minimum social transfers:

- low taxation may raise poverty by impeding the regulatory/redistributive role of the State
- high direct tax rates, in contrast, may reduce investment and labor supply, increase grey economy
- for same tax/GDP rate, progressive taxes have greater impact on poverty

Inflation and poverty

High inflation is <u>bad for growth:</u>

- Creates uncertainty about future returns
- Erodes real value of financial assets

High inflation is also bad for <u>poverty:</u>

- ‘Inflation tax’ affects mainly the poor who cannot dollarize
- Can cause faster increase in price of essentials

<u>What is optimal inflation rate?</u>

- Certainly not zero, as expectations of price raise output
- Varies with country. Survey by Stiglitz: >40% and below is okay

BOP and poverty

In the short term, a BoP deficit allows faster growth especially if new production has large tradeable content.

But persistent deficits can:

- Draw down scarce currency reserves
- Put pressure on exchange rate → over-depreciation/rationing
- May create uncertainty and encourage capital flight

What is the sustainable BoP deficit? Depends on its duration and capital balance

Uzbekistan:
The 1991-2003 approach

- ISI industries as engine of growth, employment and poverty reduction,
- Strong human capital – redistributive policy
- Macroeconomic policy: second best but successful
- Weak labour market policy
- Limited institutional innovation

A proposed plan for Uzbekistan

BUDGET DEFICIT

Sustain the low budget deficit achieved in recent years through:

- moderate fiscal-monetary stance
- ‘budget target’

Consolidate the deficit of quasi-fiscal operations:

- more explicit attention to ‘contingent liabilities’ and effective public debt

INFLATION

- Gradually reduce inflation to 10-15% a year
- Without resorting to strict monetary/fiscal measures that impact the poor disproportionately

TAXATION LEVEL

- Obtain same low deficit from slightly lower taxation/expenditure (some 2 points of GDP)

- Redistribute tax burden equitably
  - ‘horizontally’ (between formal & informal sector)
  - ‘vertically’ (between income groups)
  - eliminate exemptions, deductions and privileges

PRICING POLICIES

Raise gradually the prices of cotton and wheat:

- Cotton. This would raise incomes for most rural population and benefit most in relative terms the poor farmers
- Wheat. Raising prises would have an important but smaller impact on poverty.
- Also, adjust gradually the energy prices

TRADE PROTECTION

- Protection of some <u>‘infant industries’</u> is needed. Government has a role in developing industrial policy
- But industrial policy needs to be recast so as to avoid its negative distributive-growth effects and ‘capture’ of national market by domestic firms (that raise prices)

EXPORT PROMOTION

The aim is to diversify the export basket via:

- competitive exchange rate helping both ‘new’ and traditional exports
- export subsidies linked to ‘export targets’
- removal of export taxes, reimbursement of VAT
- support to consortia to foster SMEs’ exports
- selective tariff cuts on non-competing imports and inputs for the export sector
- avoid overall import liberalisation

EXCHANGE RATE

- In conditions of foreign exchange scarcity, the market rate may not be a good index of the ‘equilibrium’ rate

- Thus, free floats can be unstable, cause uncertainty. Managed floats is likely the best solution

- Foreign exchange regime:
    - retain partial surrender of forex to ensure supply to priority sectors
    - gradual move to full current account convertibility (retain controls for non-essential transactions)

INVESTMENT FLOWS

FDIs:

- Subject to broad license (as in Malaysia) to assess ex ante effect on BOP, investment, and employment
- Sustain clear property rights of FDI, 100% shareholding and profit remittances
- Remove other obstacles (access to forex, taxation, bureaucratic complications)

Short-term portfolio flows:

- Keep existing controls in place
- Limit foreign borrowing by banks/enterprises