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## The Macro Content of the PRSPs: Assessing the Need for a more Flexible Macroeconomic Policy Framework

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# **The Macro Content of the PRSPs: Assessing the Need for a more Flexible Macroeconomic Policy Framework<sup>1</sup>**

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*This paper analyses the macroeconomic content of 15 PRSPs from a growth and poverty reduction perspective. It finds that, in the main and contrary to new trends in developed and middle income countries, their macroeconomic policy frameworks lack the necessary flexibility to deal with external shocks and to appropriately address macroeconomic volatility. To illustrate the point, their fiscal and monetary policies are too narrowly focused on fiscal balance and price stability, and as a consequence pay too little attention to sharp economic fluctuations arising from external shocks. The paper argues that this is problematic, as sharp macro volatility have major effects on poverty and long-term growth. PRSP countries are particularly vulnerable to external shocks such as a fall in the terms of trade due to their narrow economic structures and heavy reliance on a few primary commodities as export earnings and as sources of fiscal revenues. To reduce macroeconomic volatility, the paper proposes a set of policy measures including: avoidance of excessively tight inflation and fiscal targets (with provisions for fluctuations in their commodity prices), more room for counter-cyclical policy and the adoption of safety nets.*

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## 1. Introduction

In the past 25 years or so, the Bretton Woods institutions have encouraged developing countries to undertake economic and liberalisation reforms. The intended outcome was greater economic stability, growth and ultimately poverty alleviation. There is a growing consensus today that, although some countries have made progress in attaining growth and poverty reduction, in many cases the results have been disappointing. Many developing countries have experienced relatively poor growth performance, and, in some cases, the living conditions of the poor have worsened rather than improved.

The reforms have included trade and capital account liberalisation. A number of countries that have liberalised their capital accounts succeeded in attracting international private capital flows – the so called emerging market economies. However, these flows have shown to be highly volatile, and as a result, this group of countries suffered from a high degree of financial volatility, in many cases resulting in financial crises that were developmentally very costly (see, for example, Griffith-Jones and Ocampo, 2000). Unlike the emerging market economies, the poorer countries were unable to attract large amounts of private capital flows, remaining dependent on official flows to finance their balance of payments needs. However, these countries also suffered from high volatility, caused by a variety of exogenous shocks, such as terms of trade shocks and natural disasters. The intended benefits associated with the liberalisation reforms thus failed to materialise, causing sharp disillusionment, especially among the poorer countries.

In face of that, the international thinking seems to be slowly converging towards the recognition that alternative policies are needed, to appropriately deal with the macroeconomic volatility developing countries are subject to in a fairly liberalised, global economy (ECLAC, 2002; Kuczynski and Williamson, 2003; Cagatay et al., 2000). In this new context, a number of alternative macroeconomic policies have been proposed for adoption in developing countries. These are mainly countercyclical policies, aimed at addressing macroeconomic volatility and their negative effects on growth, employment and the living conditions, particularly of the poor. Even the larger European economies, which are suffering from lack of flexibility due to policies they have to follow under the Stability and Growth Pact, are searching for more room for counter-cyclical actions to deal with their persistently weak macroeconomic conditions.

At the same time, under the HIPC context, the poorer countries have been encouraged to adopt poverty reduction strategies, and in this regard to prepare poverty reduction strategy papers (PRSPs), as a condition for debt relief. The PRSPs have meant putting together a development strategy that should contribute to poverty alleviation and thereby to the achievement of the millennium development goals set by the international community. To this end, they have proposed the adoption of a wide range of economic policies (macro, sectoral, structural) and institutional reforms; and have included innovative elements, such as the engagement of the civil society through the participatory process, the focus on governance issues, and alternative social policies.

Disappointingly, despite a growing interest in alternative macroeconomic policies both in developed and middle-income countries, and a commitment by the PRSP process to innovate, what it seems is that the macroeconomic policies the PRSPs have been formulating have essentially been a continuation of those policies adopted by the majority of the PRSP countries under the Structural Adjustment Programmes (SAPs) during the 1980s and 1990s.

The purpose of this paper is to shed some more light on this important issue, by analysing the macroeconomic content of the PRSPs. The objectives are, first, to assess the PRSPs' macroeconomic policies from a growth and poverty reduction perspective. And second, to see whether the PRSPs have introduced alternative policies into their proposed macroeconomic policy frameworks. In particular, it will assess to what extent new elements exist that can give macro policies more flexibility to deal with macroeconomic volatility - thus following trends elsewhere, or whether innovative elements permeating the PRSPs have been limited mainly to the participatory process, governance issues and social policies. By doing so, this paper fills an important research gap, as most work on PRSPs to date has focused on the participatory process,<sup>2</sup> with much less effort being devoted to analysing the substance of the PRSPs, particularly their core macroeconomic policies. The existing analysis of the content of PRSPs has focused on budgetary issues, e.g. how resources can be re-directed/increased towards the social sectors and benefit the poor more effectively, or on structural reforms.<sup>3</sup>

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<sup>2</sup> See, for example, Booth (2001), who analyses the PRSP processes in 8 African countries, and Jenkins and Tsoka (2001), who discusses the PRSP experience in Malawi, both with a focus on participation and institutionalisation issues.

<sup>3</sup> Bevan and Adam (2001) may be among the few exceptions on work focusing on PRSP's macroeconomic policies.

This paper will thus analyse the macroeconomic content of the PRSPs of 15 countries.<sup>4</sup> The analysis will be carried out on a comparative basis, whereby we aim to identify those macroeconomic policies that have been commonly proposed by the PRSPs, as well as those policies that are country specific. Where it has clearly been the case, it will indicate what policies seem in reality to be in conflict, rather than in accordance, with the PRSP's broad aims. The paper will also identify the main growth targets specified in the PRSPs, and, where these targets look too ambitious (for example, when measured against past performance), it will examine whether specific macroeconomic policies have been designed for the purpose of making these targets feasible. Finally, it will try to find out whether (and if so, to what extent) innovative policy/mechanisms have been proposed, especially for dealing with macroeconomic volatility and exogenous shocks.

The paper is organised in 6 sections. Section 2 briefly reviews the literature on the link between volatility in macroeconomic variables on the one hand, and growth and poverty on the other, and then provides an assessment of whether the macroeconomic conditions facing (and instruments at disposal of) the countries at the entry point of their PRSPs were adequate to address macroeconomic volatility and support growth and poverty reduction. Section 3 summarises the common features of the PRSPs under examination. Section 4 analyses the macroeconomic content of the PRSPs, in four sub-sections under the headings: 1) the growth targets; 2) the monetary framework; 3) the fiscal framework; and 4) the exchange rate policy. Section 5 provides a set of policy recommendations for adoption by the PRSPs, to support growth and poverty reduction. Section 6 concludes.

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<sup>4</sup> The countries are: Bolivia, Burkina Faso, Ethiopia, Honduras, Malawi, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, Vietnam and Zambia.

## 2. The links between volatility, growth and poverty

This paper emphasises the need for dealing with external shocks and macroeconomic volatility under the premise that volatility is bad both for growth and poverty reduction. But what has the literature said more recently about the links between volatility, growth and poverty?

There is a broad consensus in the literature that volatility in macroeconomic variables is likely to hurt growth. Hnatkovska and Loayza (2003) have empirically demonstrated that macroeconomic volatility and growth are negatively correlated, and that this is especially true among poor countries, which are among other things unable to pursue countercyclical fiscal policy. What about volatility in specific macroeconomic variables, such as inflation, terms of trade and exchange rates?

Driffill et al. (1990) have theoretically shown that variability in inflation variables has a negative impact on growth. Inflation variability affects growth by creating uncertainty among investors and blurring price signals (Fisher, 1993; Smyth, 1994; Kormendi and Meguire, 1985). The hypothesis that inflation variability hurts growth has been tested and confirmed in Judson and Oprhanides (1996), among others.

Bleaney and Greenway (2001) focusing on terms of trade and real exchange rate, found using a sample for 14 sub-Saharan African countries that volatility in the terms of trade variable has a negative impact on growth. This result confirms previous work by Bleaney (1996) and Cottani et al. (1990).

A recent study by the IMF confirms these findings. It reports on the basis of both cross-country and country-specific evidence that exogenous shocks, including terms



of trade shocks, can have a negative effect on growth. In addition, the study reports that shocks can have a major impact on poverty, unless targeted safety nets are in place to mitigate their poverty effects. Furthermore, volatility may affect the poor not only through a fall in their income, but also by increasing their sense of vulnerability and insecurity, which are important poverty dimensions (World Bank, 2000; Alarcon, 2001).

If volatility is bad for growth and poverty reduction, the question that then arises is: to what extent are the PRSP countries designing macroeconomic policies to deal with this crucial issue, and to address growth and poverty reduction directly? More broadly, how similar or different are the macroeconomic policies proposed under the PRSPs to the structural adjustment programmes (SAPs) supported by the World Bank? Finally, what macroeconomic conditions were PRSP countries facing at the beginning of the PRSP process, and were these conditions appropriate to address the challenges of macroeconomic volatility, growth and poverty reduction?

SAPs were initially adopted in the 1980s in response to balance of payments (BOP) crises facing developing countries. The diagnosis was that BOP crises reflected not only poor demand management, but also problems of structural nature. Therefore, SAPs' objectives included not just macroeconomic stability, to be achieved through demand management policies, but also long-term supply response, to be engendered through a change in relative prices (to the benefit of tradable and rural sectors), and the reduction of the State in economic activities (Demery, 1994). These intermediate objectives were expected to be achieved through: macroeconomic discipline, trade liberalisation, the liberalisation of product and factor markets, financial sector

reforms, and privatisation of state-owned enterprises. These measures were expected to ultimately increase economic efficiency and enhance economic growth.

Broadly, it is possible to see that the policies under the PRSPs and SAPs look very similar. But a key difference exists regarding the growth and poverty reduction objectives. In the case of SAPs, growth was an intended objective to be achieved in the long-term through structural reforms, while poverty reduction was not explicitly pursued, although it was also a desired objective. In the case of the PRSPs, both growth and poverty reduction are direct policy objectives. However, as will be seen below, the greater emphasis the PRSPs give to these objectives is translated into short-term concrete actions to address only poverty reduction. This is done mainly through the adoption of a clear pro-poor bias in its budgetary planning. To address growth, the PRSPs are limited to the same set of structural reforms aimed at achieving growth enhancement in the long term. As was the case under SAPs, short-term macroeconomic policies are focused mainly on macroeconomic stability, the latter understood in a narrow sense – price stability and budgetary balance.

As a result of efforts to achieve macroeconomic stability under SAPs, at the time PRSP countries were formulating their poverty reduction strategies, they had already considerably reduced their inflation levels and made strides towards fiscal balance (see sections below). However, they were still facing important macroeconomic management challenges to be able to address broader macroeconomic volatility and promote more rapid economic growth.

Table 1. Selected Macroeconomic Indicators<sup>1</sup>

	<u>Exchange rate regime</u>	<b>Foreign exchange reserve indicators</b>		M2/GDP	Tax revenue % GDP	Domestic debt % GDP <sup>3</sup>
		Reserves as a proportion of GDP %	Reserves in months of imports			
<b>Bolivia</b>	Crawling peg	11.7	5.9	49.6	14	Nd
<b>Burkina Faso</b>	Fixed	9.9	4.7	19.9	11.4	18
<b>Ethiopia</b>	Managed floating	7.5	2.9	42.2	11.5	42.2
<b>Hondura s</b>	Crawling peg	23.2	4.7	45.5	17.5	4.25
<b>Malawi</b>	Managed floating	14.1	2.5	16.2	15	Nd
<b>Mauritan ia<sup>2</sup></b>	Managed floating	20	6.2	16.6	15.7	Nd
<b>Mozambi que</b>	Independe ntly floating	16	4.7	25.5	11	Nd
<b>Nicaragu a</b>	Crawling peg	13.6	2.7	17.7	27.6	42.2
<b>Niger</b>	Fixed	1.9	1.1	7.5	7.94	24
<b>Rwanda</b>	Independe ntly floaring	9.3	4.5	15.6	9.8	13.8
<b>Senegal</b>	Fixed	8.6	2.5	24.6	16.8	6.7
<b>Tanzania</b>	Independe ntly floating	9	4.1	18.9	10.1	14.6
<b>Uganda</b>	Independe ntly floating	14.4	4.8	14.4	10.4	4.9
<b>Vietnam</b>	Crawling peg	36.4	2.8	36.4	16.2	Nd
<b>Zambia<sup>2</sup></b>	Independe ntly floating	16.9	0.4	16.9	17.16	19.3

Sources: IMF and World Development Indicators and PRSPs. 1. Information refers to the year 1999, unless otherwise indicated. 2. Year 1997. 3. Year 2000, except for Niger and Rwanda, which are 1999. 4. Year 2000. 5. Year 1998. 6. Year 1999.

For example, as Table 1 shows, whilst some countries had already moved to institutional arrangements such as more flexible exchange rate regimes, some were still sticking with fixed or semi-fixed regimes. That implied they little space for pursuing autonomous monetary policy, in addition to putting them in a position of greater vulnerability to external shocks. Moreover, as the monetary and foreign exchange reserve indicators show, most countries still lacked depth in financial

markets and had limited foreign reserves to be able to conduct monetary and exchange rate policies meaningfully. Furthermore, their low tax revenue levels and, in some cases, large domestic debt service obligations (implied by the debt indicator) indicated clear constraints for pursuing effective policies aimed at fiscal balance and sustainability.

These elements were compounded by structural features that make their macroeconomic predicaments worse, regardless of many years of SAPs: their exports are concentrated on very few primary products. Their export base is therefore weak, which makes them very vulnerable to terms of trade and other external shocks. A further common characteristic these countries share is their fragile banking systems, low savings rate, large savings-investment gap, large fiscal deficits (before grants) and therefore strong dependence on foreign aid.

## 2. PRSPs: overview of their common features

In recognition that poverty is prevalent and that the resources are limited among the countries adopting PRSPs, all the PRSPs under analysis place sustainable economic growth at the forefront of their poverty reduction strategies. Accordingly, virtually all Papers have clearly set ambitious growth targets. Having established growth as the key factor in contributing to overcoming poverty, the PRSPs recognise that although growth is a necessary condition for poverty reduction, it is not sufficient. In line with the current international thinking in development (World Bank, 2000; DFID, 2000), they argue that growth should be broad based to ensure a rapid decline in poverty levels.

Thus, all PRSPs aim to promote rapid and sustainable economic growth, but stress that growth has to be pro-poor. The key elements the PRSPs propose to accelerate growth are, first, increased investment in human capital, and economic and social infrastructure; second, the promotion of a stable macroeconomic environment; and, third, structural and institutional reforms. The latter two elements are expected to contribute to growth through providing the private sector with the appropriate incentives for investment and by enhancing the level of competitiveness in the economy.

The Papers expect to achieve a stable macroeconomic environment through the adoption of prudent macroeconomic policies, particularly in the monetary and fiscal domains. Typically, the envisaged monetary policy is aimed primarily at guaranteeing low inflation, and, where inflation has been high, at lowering it towards international levels. The advocated policy instrument for achieving these objectives usually is the use of monetary targets. In order to make the targets feasible and credible, emphasis is put on de-linking monetary expansion from fiscal demands and on promoting central bank autonomy. The proposed fiscal policy, in turn, is normally the one based on the adoption of balanced government budgets, although in a few cases the stated objective is limited to ensuring fiscal sustainability, with allowance for fiscal deficits in the short to the medium term.

Strengthening the external sector is a further aim of the macroeconomic policies.

Most PRSPs acknowledge that maintaining competitive exchange rates is a key instrument for achieving this objective. The latter is seen as particularly important for

supporting export growth and diversification, considered as crucial for generating foreign exchange and providing a major source of demand for the domestic economy.

The proposed structural policies and reforms include mainly (though not only) labour, tax, financial sector and trade reforms. The central objectives of the labour reforms are to make the labour markets flexible and to improve the productivity of the labour force. The importance attached to the latter is based on the assessment that the productivity of labour is very low. This assessment is made especially by the PRSPs of those countries that have experienced poor growth performance in the past. The tax reform, intended to deliver a more rational tax system, is expected to provide incentives to the private sector to produce and invest. Moreover, it is expected to provide additional resources for public capital and social expenditures. Financial reform, in turn, is aimed at ensuring stability of the financial system, contributing to its development and making it an important source of finance for the economy. Finally, the trade reform, though not clearly specified, is aimed at boosting the external competitiveness of the economy. Importance to the trade reform is attached particularly by the PRSPs of those countries that have been slow at adopting structural reforms under the World Bank-led structural adjustment programmes (SAPs) or that have not adopted these programmes at all.

To ensure that the poor can benefit from the growth process, many PRSPs propose a development strategy that prioritises agricultural development. Moreover, a key component of all PRSPs is the distribution of fiscal resources. Budgetary allocation, the Papers stress, should prioritise spending on poverty reduction programmes and basic infrastructure. Further elements aimed at benefiting the poor which can be found in some PRSPs (but not all) include asset redistribution and provision of micro-credit.

These elements - asset redistribution, micro-credit and improved infrastructure - put together are expected to enhance the capacity of the poor to produce and generate income, through giving them access to assets, credit and markets.

As mentioned earlier, all PRSP countries are very vulnerable to external shocks. This is amply acknowledged by all PRSPs. However, very few Papers propose policies that can be used to prevent, or at least cope with the immediate economic and social consequences of these shocks and the volatility that they generate in the economy.

Finally, a common factor among the PRSPs is the near absence of targeting capital account liberalisation as part of the package of liberalisation reforms. In our judgement, this is a very positive aspect, which apparently reflects the current consensus among the Bretton Woods' institutions and the international financial community at large around a cautious approach towards full capital account convertibility. The negative aspect of it is that some of the 15 countries have already fully liberalised their capital account, but there is hardly any discussion of the possible negative implications, or how these could be tackled.

Having provided an overview of the main common elements contained in the PRSPs' development strategies, in what follows we will discuss in more depth their macroeconomic content, focusing on the core macroeconomic policies and targets. These are the growth targets, and monetary, fiscal and exchange rate policies. The purpose is to identify their main characteristics and shortcomings, with a view to informing the PRSP process.

### 3. Analysis of the Macroeconomic Content of PRSPs

#### 3.1. The Growth Targets

All PRSPs identify rapid and sustainable growth as key to reduce poverty.

Accordingly, they all have clearly stipulated growth targets. These were set taking into account the countries' growth performance in the 1990s, as the latter can give an indication of how much growth they can realistically aim for.

**Table 2. GDP growth in the 1990s and the PRSP growth targets**

	Average 1990-99	Average 1995-99	2000	Target
<b>Bolivia</b>	4.0	3.9	2.4	5.0-5.5
<b>Burkina Faso</b>	4.7	5.9	2.2	7.0-8.0
<b>Ethiopia</b>	3.7	5.4	5.4	7.0
<b>Honduras</b>	2.8	2.8	4.8	5.0-6.0
<b>Malawi</b>	4.2	7.0	1.7	5.0
<b>Mauritania</b>	3.4	4.2	5.2	8.0
<b>Mozambique</b>	5.7	8.5	1.6	7.0
<b>Nicaragua</b>	2.9	5.1	4.3	4.5
<b>Niger</b>	1.9	3.7	0.1	4.0
<b>Rwanda</b>	2.1	15.7	5.6	7.0
<b>Senegal</b>	3.3	5.3	5.6	7.0-8.0
<b>Tanzania</b>	3.1	3.8	5.1	5.0-6.0
<b>Uganda</b>	6.9	7.7	3.5	7.0
<b>Vietnam</b>	7.4	7.5	5.5	8.0
<b>Zambia</b>	0.3	1.5	3.5	4.0

Source: World Development Indicators, and PRSP documents.

As can be seen in Table 2, some countries experienced rapid growth in the 1990s. For example, Vietnam, Uganda and Mozambique exhibited an average growth of 7.4%, 6.9% and 5.7%, respectively. Other countries grew less rapidly over the decade, but still growth was moderately high. This was the case of Burkina Faso, Bolivia and Malawi, all the three countries experiencing growth rates of or above 4%. In other cases, growth picked up in the second half of the 1990s, i.e. Ethiopia, Mauritania, Nicaragua, Rwanda, Senegal and Tanzania. Finally, growth was disappointing throughout the decade for Honduras, Niger and Zambia.



In 2000, the picture changes, with some moderate and strong performers in the 1990s experiencing a decline in growth (e.g. Bolivia, Burkina Faso, Malawi, Mozambique and Uganda), due to terms of trade shocks and natural disasters. In contrast, Honduras witnessed accelerated growth in 2000 after a decade of relatively poor performance.

Because the recent growth patterns in the 15 countries were somewhat dissimilar, the proposed targets among countries are different as well, varying between annual average growth of 4% and 8% (Table 2). However, as Table 2 shows, for almost all countries the growth targets were set above (or well above) the average growth of the 1990s (or even the second half of the 1990s when growth speeded up for some countries). In some cases, the target is close to the picks of the trends observed in the 1990s, which differ considerably from the average trend due to large variations in growth rates over the whole period. The question that then arises is: are these targets feasible?

Two factors seem to stand in the countries' way to meet these targets. The first refers to lack of clearly quantifiable additional sources of finance needed to support more rapid growth. The second refers to growth volatility and the lack of instruments to make it less volatile.

As regards the source of financing, crude calculations show that the investment rates required for achieving the growth targets are well above those rates observed in the second half of the 1990s or even in 2000 (Mozambique, Nicaragua, Niger and Rwanda are exceptions to that; see Table 3). However, no clear additional financing sources have been identified in quantifiable ways to support the higher investment

needed for higher growth. Higher investment is expected to come mainly from the private sector, as a response of the intended structural reforms. A further channel by which private investment is expected to increase thus contributing to partially filling the gap between current and required investment is through fiscal tightening. The rationale is that the latter would result in lower interest rates and less financial crowding-out, therefore releasing resources for the private sector to invest. These are not quantified, however.

Public investment, in turn, is expected to be higher, as an increase in public capital expenditure is predicted. But additional resources needed to support higher public investment would have to come from the HIPC initiative or made available through an increase in external official assistance (other than HIPC). However, the HIPC resources are intended mainly to finance recurrent expenditure, e.g. health, education, while an increase in external assistance beyond HIPC, though possible, is not guaranteed. An additional envisaged financing source of public investment is increased government revenues, as a result of tax reform. Some countries project the expected increase in tax revenues, but these are based on very optimistic assumptions on growth and on the capacity of specific taxes, e.g. VAT, to provide increased revenues.

**Table 3. Level of Investment Needed to Meet the Growth Targets**

	<b>Growth Targets</b>	<b>Investment/GDP (average 1996-2000)</b>	<b>Investment/GDP Year 2000</b>	<b>Investment/GDP Required to Meet the Growth Targets<sup>1</sup></b>
<b>Bolivia</b>	5.0-5.5	19.1	17.2	23.0-25.4
<b>Burkina Faso</b>	7.0-8.0	27.6	25.5	32.2-36.8
<b>Ethiopia</b>	7.0	16.5	15.3	18.4
<b>Honduras</b>	5.0-6.0	32.4	32.5	37.3-44.8
<b>Malawi</b>	5.0	12.9	12.5	15.5
<b>Mauritania</b>	8.0	20.6	30.3	35.4
<b>Mozambique</b>	7.0	28.6	39.6	17.6
<b>Nicaragua</b>	4.5	30.8 <sup>2</sup>	24.22 <sup>3</sup>	25.4
<b>Niger</b>	4.0	10.6	10.8	10.7 <sup>4</sup>
<b>Rwanda</b>	7.0	15.5	17.5	12.6
<b>Senegal</b>	7.0-8.0	18.8	19.8	23.9-27.3
<b>Tanzania</b>	5.0-6.0	15.7	17.6	20.1-24.1
<b>Uganda</b>	7.0	17.7	19.8	22.3
<b>Vietnam</b>	8.0	28.5	29.6	35.7
<b>Zambia</b>	4.0	16.0	18.7	19.5

Source: World Development Indicators.

<sup>1</sup> Calculated using the countries' average incremental-capital output ratios (ICOR) over the 1996-2000 period, with years marked by deep recession (often caused by exogenous shocks) being taken out.

<sup>2</sup> Average 1996-1998. <sup>3</sup> Refers to the year 1998. <sup>4</sup> ICOR over the 1995-1998 period.

In these countries, the productivity of their factors of production is admittedly low; an increase in it could partially compensate for lack of higher investment. This increase is expected to take place as a result of the intended structural reforms (tax, trade liberalisation, etc.). However, even if executed as planned, these reforms would have their effects on the productivity of the factors of production only fully felt in the medium to long term. Moreover, these effects may be smaller than expected.

Growth volatility may represent a second deterrent to more rapid growth. It is already high among this group of countries, and may become more intense as the economies become more open. It can affect growth, especially its long-term trend, through uncertainty it creates among private investors, both foreign and domestic; and secondly, by causing a decline in government revenues, which can in turn reinforce the initial decline in growth.

Unfortunately, although the PRSPs stress the need for macroeconomic stability, the focus is on price stability and fiscal balance, believed to be the key elements to underpin overall macroeconomic stability; as a consequence, both the proposed monetary and fiscal frameworks are designed to support these two objectives only (see below). These frameworks do not contain any monetary devices or counter-cyclical fiscal elements, to prop up domestic demand when it declines. They therefore lack any meaningful mechanisms that can help smooth out aggregate demand.

Even where counter-cyclical elements exist (see below), a further problem is that more often than not the decline in growth may not be related to the downturn phase of the business cycle, but, rather, caused by external shocks. These shocks are so frequent and the volatility they cause so deep – and even disruptive –, that in the face of this, the volatility associated with the business cycles may look as a problem of secondary importance. However, the PRSPs lack countervailing mechanisms that can be activated when the economy is hit by these shocks.

The majority of the Papers acknowledge that the growth targets may be rather ambitious. In response to that, a few of them propose alternative targets, based on less optimistic scenarios.<sup>5</sup> This was the case of the PRSPs for Niger, whose growth performance at the time of the PRSP formulation was rather weak due to unfavourable weather conditions; Senegal, which acknowledges the impact of external shocks on growth and even provides simulations of this impact on growth performance (although it does not elaborate on how to deal with this impact); and Uganda, where growth slowed down in 2000 after strong growth performance in the

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<sup>5</sup> The IMF progress assessments of the PRSPs reach similar conclusions (see IMF PRSP Annual Progress Report, various issues).

1990s; in fact, in 2001 the target was not met, due to a deterioration in the country's terms of trade (coffee and oil prices), drought and EU ban on fish exports.

The reason for setting growth targets so high is that by only growing very fast these countries will be able to reduce poverty significantly, as pointed out earlier.

According to calculations provided by Hanmer et al. (1999), to meet the millennium goal of halving extreme poverty by 2015, Sub-Saharan countries would have to grow at over 8% per annum.<sup>6</sup> This figure is higher than the growth targets set by the eleven Sub-Saharan countries of our sample (except for Mauritania; see Table 2). This indicates that, although already high, the current growth targets may not be sufficient to meet the poverty reduction targets for 2015. This further indicates that lower growth targets, although more realistic, may leave poor countries even farther away from the millennium development goals, unless, of course, growth is accompanied with better income distribution.

In sum, the growth targets set by the PRSPs look quite ambitious (even if still not sufficient to meet the poverty reduction goals), first because possible additional sources of finance seem improbable to become available in the short term, and are not even appropriately quantified. Second, because the volatility of growth, which has strongly marked the PRSP countries in the past, if exacerbated may lower these countries' growth trends.

In recognition that volatility in growth (and other economic variables) caused by terms of trade shocks and natural disasters is a major problem facing poor countries, the IMF has put forward a proposal to increase the external financial assistance to

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<sup>6</sup> It should be noted that the authors reach this figure under the assumption that there will be no improvement in income distribution.

countries facing external shocks (IMF, 2003). At the national level, however, the countries' macroeconomic frameworks include very few mechanisms to deal with shocks (see below).

### 3.2. The Monetary Framework

Nearly all Papers propose a monetary policy focused on price stability. To show firm commitment to this policy goal, they set quantitative targets for inflation. Table 4 shows that the targets for annual inflation are very low, ranging between 3% and 5%. Honduras is the only country outside this range, with a target of 9%. At the same time, Table 4 shows that current inflation is already at, or below, the established targets for many countries.<sup>7</sup> In these circumstances the objective is to ensure that inflation is kept at the current levels, or even to bring it further down to a very low level.

**Table 4. Inflation in the 1990s and the PRSP inflation targets %**

	Average 1990-99	Average 1995-99	2000	Target
<b>Burkina Faso</b>	4.5	4.0	-0.3	3.0
<b>Bolivia</b>	10.4	7.4	4.6	4.0
<b>Ethiopia</b>	7.8	3.2	-0.04	5.0
<b>Honduras</b>	19.7	19.8	10.1 <sup>1</sup>	9.0
<b>Malawi</b>	31.0	40.9	29.5	4.0
<b>Mauritania</b>	6.4	5.6	3.3	5.0
<b>Mozambique</b>	34.1	22.1	Na	3.0
<b>Nicaragua</b>	1053.7	11.2	9.9 <sup>1</sup>	4.0
<b>Niger</b>	4.3	4.2	2.9	3.0
<b>Rwanda</b>	8.6	5.8	3.9	3.0
<b>Senegal</b>	4.4	2.8	0.7	3.0
<b>Tanzania</b>	23.1	17.2	5.9	4.0
<b>Uganda</b>	15.9	5.8	2.8	5.0
<b>Vietnam</b>	Na	5.1	-1.7	Na
<b>Zambia</b> <sup>2</sup>	Na	29.7 <sup>3</sup>	26.1	Na

Source: World Development Indicators.

<sup>1</sup> ECLAC. <sup>2</sup> IMF World Economic Outlook. <sup>3</sup> 1996-1999.

<sup>7</sup> The countries are: Burkina Faso, Ethiopia, Mauritania, Niger, Senegal and Uganda.

Furthermore, Table 4 shows that inflation is on a declining trend in those countries that have not met their targets yet.<sup>8</sup> Malawi and Zambia have been exceptions to that.

Low inflation levels have been an appreciable achievement for all these countries, especially the Latin American ones, which have suffered from very high inflation in the past. Aiming for price stability is clearly consistent with the objective of poverty reduction, as high inflation tends to hurt the poor most, given their lack of access to remunerated bank accounts or other protection mechanisms against inflation.<sup>9</sup>

However, the design of their monetary policy is narrowly focused on price stability, with limited reference to other objectives. A few countries have additional objectives, such as the need to support the exchange rate policy and an increase in international reserves. But no references are found in the PRSPs to two objectives that are very important, from the poverty reduction perspective: growth and employment.

Mauritania's PRSP is perhaps the only exception to that, as it states it intends to promote monetary easing to support economic growth.

To maintain inflation low or to bring them to low levels, the Papers essentially propose the adoption of prudent monetary policy. However, they do not explain in detail through what mechanisms and rules a prudent policy might be adopted. A few Papers make reference to the adoption of money base targets and Central Bank autonomy. Box 1 summarises the proposed monetary policy for each of the 15 countries.

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<sup>8</sup> The countries that fall into this situation are: Bolivia, Honduras, Nicaragua, Rwanda and Tanzania.

<sup>9</sup> See Gottschalk (2003) for a discussion of high inflation and its implications for poverty and inequality, in the Latin American context.

### Box 1. Monetary Policy (and Objectives)

	Measures proposed in the PRSPs
<b>Burkina Faso</b>	WAEMU member country
<b>Bolivia</b>	Not specified
<b>Ethiopia</b>	Monetary targeting based on monitoring reserve and broad money
<b>Honduras</b>	To maintain an effective monetary policy; prudent liquidity management through open-market operations, mainly by auctioning Monetary Absorption Certificates; policy consistent with interest rates favourable to investment and inflation no higher than one digit.
<b>Malawi</b>	Tight monetary policy and Central Bank autonomy for avoiding financing pressure
<b>Mauritania</b>	Rigorous monetary policy to support exchange rate policy and low inflation.
<b>Mozambique</b>	To avoid monetisation of the fiscal deficit
<b>Nicaragua</b>	Inflation targeting; to reduce inflation rate to 4.0% by 2005.
<b>Niger</b>	WAEMU member country
<b>Rwanda</b>	Broad money targeting
<b>Senegal</b>	WAEMU member country
<b>Tanzania</b>	Prudent monetary policy (not further specified)
<b>Uganda</b>	Monetary targeting; growth rate of M2 of 15%.
<b>Vietnam</b>	Prudent monetary policy; introduction of monetary and credit controls aimed at improving the effectiveness of policy monitoring and meeting the targeted objectives.
<b>Zambia</b>	To make open market operations more transparent and to grant the Central Bank greater legal and operational autonomy

Sources: countries' PRSPs.

The vagueness in the specification of the monetary policy may be explained mainly by the countries' lack of monetary instruments to control liquidity in an effective way. Moreover, the countries lack technical and monitoring capacity for implementing effectively a carefully designed monetary policy. In some cases, liquidity has been excessive at times even when prudent fiscal policy is being pursued, due to a boom in foreign investment and the release of resources by the HIPC initiative. This has posed a challenge for the monetary authorities, and in recognition to that, no specific targets have been stipulated.<sup>10</sup>

Burkina Faso, Niger and Senegal are WAEMU member countries.<sup>11</sup> They therefore differ from the other countries for sharing a common currency, the CFA Franc, and for not having their own monetary policy, as this was handed over to the Central Bank of West African States (BCEAO).

<sup>10</sup> Tanzania has been a case in point - see Gottschalk and Griffith-Jones (2002).

<sup>11</sup> WAEMU stands for West African Economic and Monetary Union. It comprises the following countries: Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.



In light of the above, it is possible to identify two main facts. First, almost all PRSP countries have already achieved price stability, but have not adapted their monetary policy to this new reality, by broadening its focus to encompass the growth and employment objectives. Moreover, it is important to note that in many countries inflation is already at very low levels; aiming for an even lower inflation may not be cost-effective. Second, the countries have suffered from lack of instruments for an effective monetary policy. In recognition of that, the PRSPs place a major emphasis on fiscal discipline to ensure macroeconomic stability.

### 3.3 The Fiscal Framework

The fiscal policy is presented in the PRSPs as key for ensuring macroeconomic stability. The Papers affirm that it should be prudent to ensure a balanced budget (after grants) or at least be sustainable over time. The commitment to prudent fiscal policy is a common feature underlying all Papers. Other common features in the countries' fiscal frameworks include their commitment to generating higher public revenues through tax reform (discussed further below); rationalisation of public expenditure; and, above all, reallocation of public expenditure towards poverty-reduction programmes. Indeed, at the budgetary level, the proposed frameworks have an important pro-poor bias. Moreover, they have been formulated with the increasing degree of participation of the civil society, which will certainly improve the transparency and effectiveness of implementation of programmes, particularly the social ones.

**Table 5. Overall Fiscal Surplus (Incl. Grant) as % GDP**

	Average 1990-94	Average 1995-99	2000	2001
<b>Bolivia</b>	-1.9	-2.3	-3.4	-6.8
<b>Burkina Faso</b>	-3.8	-3.0	-4.3	-4.3
<b>Ethiopia</b>	-7.8	-5.1	-11.4	-5.0
<b>Honduras</b>	Na	Na	Na	Na
<b>Malawi</b>	-8.4	-5.0	-4.9	-7.3
<b>Mauritania</b>	-4.9	4.4	-1.6	-2.8
<b>Mozambique</b>	-4.2	-2.5	-4.5	-4.9
<b>Nicaragua</b>	-7.3	-1.1 <sup>1</sup>	Na	Na
<b>Niger</b>	-5.2	-3.0	-2.0	-2.4
<b>Rwanda</b>	-7.6	-3.5	0.1	-1.1
<b>Senegal</b>	-1.6	0.9	0.3	-1.9
<b>Tanzania</b>	1.8	-0.6	-1.2	-0.7
<b>Uganda</b>	-4.5	-1.5	-8.7	-3.0
<b>Vietnam</b>	-1.4 <sup>2</sup>	-0.8	-2.8	-2.9
<b>Zambia</b>	-5.6	-2.1	-5.0	-7.2

Sources: World Bank Africa Database for African countries; and WDI 2003 for the others.

<sup>1</sup> 1995-98. <sup>2</sup> Year 1994.

Looking at Table 5, which displays figures of the overall fiscal performance of the countries under analysis, it is possible to notice that for a number of countries the budgetary situation worsened rather than improved around the time the PRSPs were being designed. This was the case after a decade during which nearly all countries had made clear strides towards small fiscal deficits. Also, by comparing Table 5 with Table 2, which displays information on growth performance, it is possible to observe that the fiscal trends had a counter-cyclical pattern in nearly all countries. That is, as growth accelerated from the first to the second half of the 1990s, their fiscal deficits declined, and when growth slowed down in 2000, the deficits increased again.

This trend analysis should be seen with caution, as it is based on 5-year averages, therefore possibly hiding a different yearly pattern. Moreover, the averages are based on figures that vary significantly across different sources. However, if a counter-cyclical pattern in fiscal trends really exists, the PRSPs in their general commitment to budget balance do not seem to recognise either its past existence or its importance as a means of dealing with economic downturns. Yet, despite this, at a more detailed

level of analysis some degree of variation can be found across the proposed frameworks.

At one extreme, one can find Burkina Faso, Niger and Senegal. These are WAEMU member countries that have agreed to the WAEMU Convergence, Stability, Growth and Solidarity Pact. The key elements of the Pact include meeting the following convergence criteria: nominal fiscal balance, the ceiling of 35% for the ratio of the wage bill to total tax revenue, a debt to GDP ratio not higher than 70%, and annual inflation not higher than 3%.

These criteria are very stringent, especially for Niger. Consequently, these countries' room for action on fiscal matters is extremely limited, as their commitment to converging towards the WAEMU criteria takes away any flexibility for adapting their fiscal framework to their particular circumstances and needs.

Vietnam's Paper stands at the other extreme of the spectrum for focusing on revenue increase rather than on expenditure cuts to achieve fiscal balance. As the Paper puts it, their main objective is to 'improve the fiscal policy, implement reforms in the taxation system, and expand the tax base to ensure a healthy state budget balance' (Vietnam's PRSP, 2000). It moreover stands apart from the other Papers for introducing the higher number of progressive elements in its proposed fiscal framework. These include their reference to the adoption of instruments to mobilise capital, including the use of preferential taxes targeted at new investment and production expansion, the acknowledgment of the need to ensure a balance between capital expenditure and recurrent expenditure and, in the area of tax reforms, the expectation that the proposed

reform of the tax system should result in an increase in the share of revenues from direct (rather than indirect) taxes in total revenues.

The latter point is a particularly important one, as nearly all other countries that intend to undertake tax reforms emphasise the need for widening the tax base, mainly through the strengthening of the VAT, while promising to alleviate the corporate sector from a heavy tax burden. Clearly the objective of widening the tax base is an important one for countries where the tax collection system is weak and the level of tax revenues low. But it is also important to bear in mind that some of the proposed mechanisms to achieve higher tax revenue collection are clearly regressive, and even more so in countries where poverty is so deep and widespread. Unfortunately, this fact is not acknowledged in the PRSPs.

As regards the remaining PRSPs, a few interesting elements can also be found in their proposed fiscal frameworks. That is, it is possible to identify a number of specific measures and mechanisms some of which innovative, aimed among other things at supporting growth and the most vulnerable. These can be summarised as follows.

First, whilst supporting fiscal balance on principle, a few countries' fiscal frameworks foresee the increase in the fiscal deficits, a development seen as necessary in the short term to deal with terms of trade shocks and other unexpected events. Uganda and Zambia are two cases in point. Second, Mauritania proposes an easing in its budgetary policy to finance investment to support economic growth; in addition, it states clearly that additional expenditure is PRSP related, thereby making it clear that these are planned ex-ante and justified from a poverty reduction strategy perspective. And third, Rwanda proposes an increase in public expenditure in social infrastructure and

services to avoid their erosion or even collapse, therefore ensuring long-term sustainability. Also, it envisages the possibility of an increase in capital expenditure above long-term levels, if additional funds are made available. Furthermore, it proposes the creation of new financial mechanisms to smooth out expenditures in times of revenue fluctuations.

All these proposed initiatives show the countries cited above introduced a few elements in their fiscal frameworks that allow for some flexibility. Because increased deficits are predicted, intended to have either a counter-cyclical role (as in the cases of Uganda and Zambia), or a link to long-term sustainability of basic services (as in the case of Rwanda) or of the growth process more broadly (as in the case of Mauritania), they do not undermine, but rather reinforce, the credibility of their fiscal regimes.

Increased flexibility in fiscal policy is important to enable countries to deal with volatility either associated with the business cycle or caused by exogenous shocks, so that its negative effects on growth and poverty can be reduced. As regards the effects on the latter, case studies conducted by the IMF on Cambodia, Honduras, Zimbabwe, Mali and Uganda show that in nearly all cases poverty increased in these countries following exogenous shocks (IMF, 2003, p. 10, Box 1). Moreover, according to Ferranti et al. (2000, cited by Fiess, 2002), social expenditures, and in particular targeted expenditure, tend to fall during the downswing of the business cycle.

A further reason for dealing with economic volatility is that both their growth and poverty impacts are asymmetric - that is, the negative effects are larger than the positive ones following recovery.<sup>12</sup>

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<sup>12</sup> See Collier and Dehn (2001) for evidence on the first form of asymmetry, and the IMF (2003) on the latter.

Other interesting initiatives in the fiscal frameworks concern new modalities and sources of funding, and safety nets. As regards sources of funding, Honduras suggests the creation of a poverty reduction fund, with resources coming from debt relief and privatisation. And Senegal proposes the use of alternative sources of finance like regional markets for public debt bonds. As regards safety nets, a few countries propose the inclusion in their fiscal frameworks of safety nets to deal with shocks and their effects, and other mechanisms to deal with unexpected events. For example, Mozambique proposes programmes to reduce vulnerability to natural disasters; and Tanzania, the provision of safety nets and the undertaking of special initiatives to prevent the collapse of crop production.

Finally, Uganda proposes the creation of an equalisation grant, to tackle gender and other inequalities; Box 2 summarises the countries' main fiscal features and their innovative elements.

## Box 2. Fiscal Policy: Main Elements (and Objectives)

	Measures proposed in the PRSPs
<b>Burkina Faso</b>	Prudent budgetary policy; commitment to the WAEMU convergence criteria.
<b>Bolivia</b>	Sustainable fiscal deficits based on non-inflationary sources of finance; deficit expected to continue in the short- to medium term due to the cost of structural reforms such as pension reform; therefore need to finance priority social programmes with other resources, to be generated domestically (tax collection from VAT and import consumption tax) and to come from foreign sources like the HIPC initiative.
<b>Ethiopia</b>	Fiscal discipline based on reducing the fiscal deficit to sustainable levels and reorienting expenditure, especially towards agriculture, health and education; increase in tax revenue from 14.3% to 17.7% of GDP through tax reform; moving forward towards fiscal federalism. Acknowledgement that macroeconomic discipline is dependent on structural factors and external shocks.
<b>Honduras</b>	Low fiscal deficit through firm control over fiscal expenditures; fiscal revenue strengthening through enlarging sales tax, improving the customs valuation system, and modifying the Income Tax Law; efforts to improve tax administration; rationalisation of public expenditure should give priority to poverty-reduction programmes; creation of a poverty reduction fund (with resources coming from debt relief and privatisation).
<b>Malawi</b>	Prudent fiscal policy; reduction of fiscal deficit aimed at reducing interest rates and crowding out, so that incentives are provided and resources made available for private investment; improving public expenditure policy management and parastatals' expenditure; more autonomy to treasury and budget to avoid pressure for financing the budget.
<b>Mauritania</b>	Sound budgetary policy in the long term; in the short- to medium term, controlled easing of budgetary policy with a view to supporting economic growth; projected medium-term budget deficit with an upward trend (from 1.5% in 2000 to 3% in 2004) as a reflection of increased public investment and other additional expenditure related to PRSP projects; increase in tax revenue through new tax reform (incl. VAT management improvement); prioritisation in the allocation of public expenditure.
<b>Mozambique</b>	Limiting budgetary expenditure; increase in fiscal revenue from 15% to 17% through income growth and tax reform; mobilising budgetary resources; dynamic approach to resource allocation, by acknowledging rapid growth is the best way of creating resources for essential public services; greater co-ordination and transparency of public expenditure; rationalisation of tax services and costumes; ensuring flow of international finance; adoption of programmes to reduce vulnerability to natural disasters.
<b>Nicaragua</b>	Rationalisation of public investment programmes (based on a bottom-up approach); increase in government spending on poverty-related outlays to 62% of the budget.
<b>Niger</b>	Strict budgetary policy; commitment to the WAEMU convergence criteria.
<b>Rwanda</b>	Programme for reduction, prioritisation and rationalisation of expenditure; tax reform, aimed at reducing corporate tax, increasing VAT and introducing new taxes; short-run increase in capital expenditure above long-term level, if funds are made available; temporary increases in public expenditure required in the short run to ensure long-term sustainability; the development of a range of financial instruments so that expenditure can be smoothed out during periods of revenue fluctuations.
<b>Senegal</b>	Commitment to the convergence criteria of the WAEMU; simplification of taxation and broadening of the tax base; public expenditure closely monitored in order to obtain a positive budget balance; use of alternative sources of finance like the regional market for public debt bonds.
<b>Tanzania</b>	Prudent fiscal policy; improvement of expenditure planning; expected increase in revenue and expenditure due to tax reform; rationalisation of the tax system; provision of additional safety nets and the undertaking of special initiatives to prevent the collapse of crop production.
<b>Uganda</b>	Prioritisation of expenditure towards the poor; overall fiscal deficit expected to increase in 1999/2000 and 2000/2001 to 8.1% and 9.7%, and to decline later to 8.2% in 2002/2003; equalisation grants.

<b>Vietnam</b>	Appropriate fiscal policy to safeguard medium-term sustainability; strengthening of the tax system; increase in the tax base through new sources of tax revenue and the efficiency of the tax payment system (while ensuring it remains pro-poor); increase in expenditures on basic social services and rural infrastructure; public expenditure bias in favour of poor provinces; increase in the budget transparency so as to improve the information base for decision-making and target setting; balance between capital investment and recurrent expenditure; adoption of preferential taxes for new investment and production expansion, technology innovation, new product development, etc.
<b>Zambia</b>	Balanced budget in 2003 and 2004; but increase in the budget deficit in the short run; need for policies to target the losers resulting from the adjustments caused by the growth process.

Sources: countries' PRSPs.

The elements just described are important because they can have a counter-cyclical role, for example in helping attenuate an economic downturn. Unfortunately, these elements are too few and not sufficiently widespread across the various proposed fiscal frameworks. This is a reason for concern, because the fiscal policy should be seen as a key one, not just for supporting stability, but also growth and poverty reduction.

It should be recognised that the room for adopting these elements may be extremely limited. As seen in Table 5, although a few countries are close to a balanced fiscal position, a number of them are not. To the latter group of countries, pursuing a counter-cyclical fiscal policy would mean distancing themselves even further from their commitment to fiscal balance. A more fundamental problem is that, given the level of their public debt (still extremely high despite the enhanced-HIPC), pursuing large fiscal deficits may not be sustainable.

A further issue in relation to the proposed frameworks concerns lack of sufficient acknowledgement of potential conflicts. A key one, likely to arise in all cases, is the conflict between the need for budgetary balance and the numerous demands associated with a development strategy that aims to support growth and combat poverty. Conflicts may also arise between different areas of the budget. For example,



the resource conflict between capital expenditure, required for growth, and recurrent expenditure, to support social programmes. Acknowledging this conflict is important given the gap between the resources needed to meet the very ambitious targets (both in terms of growth and social expenditures) set in the Papers, and the resources available in reality, which are very limited. Unfortunately, the failure to sufficiently acknowledge these conflicts, or to discuss the potential trade-offs can create expectations that may not be fulfilled.

### 3.4. The Exchange Rate Policy

The majority of the PRSPs explicitly identify the exchange rate policy as key to support their objectives of growth and poverty reduction. In this regard, they intend to adopt a competitive exchange rate, so as to improve the country's overall level of competitiveness and the export sector in particular. Prioritising the export sector implies in most cases benefiting the rural sector, where the export activities are concentrated.

A competitive exchange rate also provides some degree of effective protection to the countries' import-competing industries. This is particularly important in a context in which trade barriers may be reduced, as a result of trade liberalisation programmes.

Of course, a competitive exchange rate would affect negatively urban consumers, those rural consumers that are wage earners, and capital-importing activities. There are, therefore, important dilemmas around the exchange rate policy. But there are no general prescriptions in this case. The dilemmas facing policy makers should be

addressed with policy actions tailored to the specific structural characteristics and circumstances of each country concerned.

To ensure enhanced competitiveness, many PRSPs suggest that a flexible exchange rate may be the most appropriate regime to adopt. A flexible exchange rate regime seems in fact appropriate, not only to ensure competitiveness, but also to serve as a hedging mechanism against terms of trade and other external shocks.

A few countries like the WAEMU ones, however, are committed to a fixed exchange rate instead (see Box 3 for a summary of the proposed exchange rate regimes). They therefore do not have the ability to use the exchange rate as an instrument to support their export sectors, or as a defence mechanism against terms of trade shocks.

### **Box 3. The Exchange Rate**

	<b>Exchange rate policy/regimes proposed in the PRSPs</b>
<b>Burkina Faso</b>	Fixed (WAEMU member country)
<b>Bolivia</b>	Crawling peg (aimed at ensuring a competitive exchange rate).
<b>Ethiopia</b>	Stable exchange rate
<b>Honduras</b>	Competitive exchange rate and the avoidance of exchange rate appreciation.
<b>Malawi</b>	Not specified.
<b>Mauritania</b>	Not specified.
<b>Mozambique</b>	Maintaining a competitive exchange rate.
<b>Nicaragua</b>	Not specified.
<b>Niger</b>	Fixed exchange rate regime (WAEMU member country).
<b>Rwanda</b>	Policy based on intervention in the exchange rate to smooth short-term fluctuations while allowing it to adjust to export price movements.
<b>Senegal</b>	Fixed regime (WAEMU member country).
<b>Tanzania</b>	Not specified.
<b>Uganda</b>	Market determined with intervention to avoid excessive volatility and to maintain net international reserves.
<b>Vietnam</b>	Increased flexibility and transparency of the foreign exchange regime.
<b>Zambia</b>	Not specified.

Sources: countries' PRSPs.

Of course, the choice of a flexible exchange rate is not problem-free either, although clearly it seems far more appropriate than a fixed one. In countries subject to frequent terms of trade shocks, a fully flexible exchange rate regime may imply excessive exchange rate variability, which could hurt long-term growth through uncertainty it creates among exporters, affecting in particular those that are risk averse. In the PRSP

countries, risk-averse exporters tend to be the majority, given their lack of access to hedging instruments, which could be used against exchange rate risk. A further issue concerns the problem of possible excessive currency depreciation. This could cause inflationary pressures and major shifts in the currency asset-liability balances of the financial and other sectors of the economy. Those countries experiencing a high degree of dollarisation, such as Bolivia and Uganda, may be particularly vulnerable to excessive currency depreciation, as Argentina's recent crisis demonstrates.

An additional problem countries may face is not that of excessive currency depreciation, but of appreciation. A few PRSP countries are experiencing this problem, due to a combination of export earnings, FDI and HIPC-released resources (e.g. Tanzania). Their response has been to intervene in the foreign exchange market, which has implied the accumulation of international reserves. The latter can be seen as a positive development in itself, to the extent it can serve as an important cushion to be used in times of difficulties. However, it may also imply excessive liquidity expansion. The response to liquidity expansion may take the form of sterilisation operations, but this can be fiscally costly and difficult for the monetary authorities to manage in light of the limited number of monetary/financial instruments at their disposal.

As can be seen in Box 3, a number of PRSPs recognise some of the potential problems linked to a flexible exchange rate regime. They therefore propose a pragmatic approach, based on casual interventions in the foreign exchange markets to avoid excessive exchange rate variability; in addition, some of the proposed regimes are intended to ensure a reasonable level of international reserves.

#### 4. Policy Recommendations

The purpose of this section is to suggest a set of policy recommendations on how macroeconomic policies can be improved in the areas of monetary, fiscal and exchange rate policies, so as to support more rapid and stable growth, and poverty reduction.

1. Monetary policy. Price stability is very important to long-term growth, and therefore should be a main objective of monetary policy. However, once price stability is achieved, supporting growth and employment should also be included among the objectives of monetary policy, as indeed they are in the US and other developed countries.

How could that be done? Admittedly, PRSP countries have few monetary instruments that permit them to pursue an effective monetary policy to address multiple objectives, which sometimes are difficult to accommodate. This requires some room for manoeuvre.

In this regard, it seems important that inflation targeting, if adopted, does not have an excessively low target, nor too a narrow band, for inflation. Also, too a low inflation target may not be appropriate for these countries as they may be subject to higher price variability when compared to developed countries, given the price shocks they are subject to, and their relatively weaker production and distribution systems.

2. Fiscal policy. PRSP countries are correct in pursuing a prudent fiscal policy. This policy stance gives it credibility thereby contributing to macroeconomic stability and

long-term growth. However, prudence should be based on realistic fiscal targets, and should not preclude flexibility. As regards the latter, it should mean allowing for counter-cyclical fiscal policy. Chile, for example, has adopted a counter-cyclical element in its fiscal policy framework. In this framework, a structural fiscal surplus of 1% should be met. The structural fiscal balance is the difference between the actual fiscal balance and the cyclical component of the balance. Having a structural fiscal target rather than actual target implies that the government will be able to increase public expenditure during the downswing phase of the business cycle, and decrease it during the upswing phase (Fiess, 2002). This mechanism gives the government room for fiscal policy that can be used to stimulate demand and counter-act the negative poverty effects associated with economic recession. This is a rules-based policy, which therefore does not undermine government credibility (ECLAC, 2002).

Flexibility in the fiscal framework should be allowed for, not only to deal with the downturn of the business cycle, but also to deal with the effects of external shocks. PRSP countries are particularly affected by the latter, due to their narrow economic structures and heavy reliance of a few primary commodities as sources of fiscal revenues. A very appropriate initiative for countries with these characteristics is the creation of funds as Chile's Cooper Compensation Fund, Colombia's Oil Stabilisation Fund and, among the PRSP countries, Burkina Faso's Cotton Support Fund.<sup>13</sup> These funds, which are not sufficiently discussed in the PRSPs, could be incorporated into the countries' fiscal frameworks. Of course, these countries should attempt to diversify their economic structure and export base, but this will only be achieved in the long term. In the meantime, alternative measures should be considered.

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<sup>13</sup> For a reference to Burkina Faso's Cotton Support Fund, and the role it played in 2001-2002, when cotton prices fell sharply, see IMF (2002).

To cope with exogenous shocks and their consequences, countries should in addition follow Mozambique and Tanzania in having safety nets, as well as programmes to reduce vulnerability to natural disasters and to prevent the collapse of crop production.

Specifically as regards the WAEMU member countries, which are committed to the convergence criteria of their Stability and Growth Pact, it is important that more room be created for counter-cyclical policies. Also, it is important provisions are made for their main sources of volatility, such as fluctuations in their main commodity prices. Of course, provisions linked to commodity price fluctuations can be equally adopted by those countries not committed to a stability pact, but that still have self-imposed fiscal targets. It should be noted that flexibility in fiscal policy makes it even more credible.

Finally, it is important that the potential conflict among the numerous demands for public expenditure be appropriately addressed. It would particularly desirable that minimum thresholds be established for certain types public expenditure, such as health and education, but particularly capital expenditure, which in times of recession or crisis tends to be disproportionately reduced. A special fund could be created with the proceeds of privatisation, thus similar to the poverty fund proposed by the Honduras PRSP, to be activated when the minimum thresholds are hit.

3. Exchange rate policy. A flexible exchange rate regime should be preferable to a fixed one, as it maximises the degree of freedom of macroeconomic policy and contributes to the strengthening of the country's external sector. Nevertheless, countries should be careful with excessive volatility of the exchange rate, as this

volatility may have a negative impact on foreign trade, domestic prices and the balance-sheets of banks and non-financial companies. They should therefore be prepared to intervene in the foreign exchange market to avoid excessive volatility, and for that purpose, be able to accumulate a sizeable amount of international reserves.

## 6. Conclusion

It is important to recognise that the PRSPs have had very positive aspects. These include the participation of the civil society in the design, implementation and monitoring processes; transparency; and appreciable progress in budgetary planning and social policies. Moreover, the PRSPs have provided a unique opportunity for poor countries to have an integrated, national development strategy, something that had been missing since the late 1970s and early 1980s, when these countries embarked on market-oriented reforms.

There is a strong agreement among the PRSPs that broad-based growth should be at the centre of a development strategy. Taking that as a starting point, this paper focused on possible links between the PRSP's proposed macroeconomic policies and the PRSP's claimed objective of achieving pro-poor growth. Throughout, the evidence found was that the macroeconomic frameworks as currently designed do not really support in a direct, clear way, economic growth and poverty reduction.

The paper initially shows that most PRSPs have set quite ambitious growth and poverty reduction targets, but that the sources of growth and/or resources required to meet these targets are not always clearly identified. Moreover, the macroeconomic policies that could support growth are specified in ways to support mainly macroeconomic stability. The underlying assumption being that, provided a stable macroeconomic environment is in place, enhanced growth will ensue automatically, and ignoring the fact that in the past the same policies have not been enough to guarantee growth and poverty reduction.



The paper further shows that the macroeconomic frameworks proposed by the PRSPs have very few embedded mechanisms that can be activated to counteract the effects of macroeconomic volatility, and in particular to deal with major exogenous shocks, which tend to affect most strongly the poorest. This represents a serious problem, as virtually all countries adopting PRSPs face a situation of extreme vulnerability to shocks such as terms of trade and natural disasters.

The lack of elements in the macroeconomic frameworks that can support growth and reduce macroeconomic volatility should be seen with concern. Nowadays both developed and middle-income countries are searching for alternative macroeconomic policies, so as to appropriately address the problems they are facing in an increasingly integrated and unstable world economy. At the same time, the poorer countries are being encouraged to stick with the sort of policies that may have been useful in the past to bring about macroeconomic stability and balance of payments equilibrium, but that nonetheless have failed to support growth and reduce poverty.

Structural policies have a vital role in supporting long-term growth. Likewise, macroeconomic policies should support growth in the long term through ensuring stability. However, in the new context in which macroeconomic stability has been assured, the priorities have changed from stability to growth and poverty reduction, and it is important that the PRSPs adapt their policies to these new priorities. That is, macroeconomic policies should support growth in the short term as well, and ensure it becomes less volatile.

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