

BUDGET POLICIES AND INVESTMENTS FOR CHILDREN – A TRAINING COURSE FOR UNICEF STAFF

Module 2: Macroeconomics

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Venue: Turin

**For every child
Health, Education, Equality, Protection
ADVANCE HUMANITY**



Learning Objectives

1. To BRIEFLY explain the key concepts of Macroeconomic analysis
2. To improve awareness of the Macro IMBALANCES (e.g. a budget deficit) that can cause ECONOMIC INSTABILITY in low income countries
3. To help you understand why policy-makers face difficult TRADE-OFFs in dealing with these imbalances and instability when building anti-Poverty programmes
4. To encourage you to think about some of the ways in which budgets including social budgets can be affected by (and protected from) underlying macroeconomic circumstances

Let's understand too that Macroeconomists are not insensitive to critical social needs although this may often appear to be the case !

ORas one of your colleagues (Gaspar Fajth) put it in Florence

Macroeconomic frameworks teach us “there is no such thing as a free lunch”

It can help us understand who pays the bill (for more help to children)

It gives us hints about how the kitchen (GDP) and the bill (to help children) could be made bigger

But it tells us relatively about little who actually gets the lunch

So we need to think of macro analysis alongside BUDGET ANALYSES (another module) to get the fuller picture on who gets the lunch...

Why UNICEF should be concerned about macroeconomics?

Child rights = lack of child poverty = family/household wellbeing and reasonable social services

Macroeconomic policy impacts on ALL these by influencing among other things:

- income levels, employment and wages and so livelihoods
- household savings – the reliability off/returns on saved funds
- services available and benefits secured (via taxes levied) from governments
- money supply shaping prices and the availability/cost of financing

→ Caution: interrelationships and other factors (inter-, intra-household distribution, gender equity, values, skills, sector effectiveness, efficiency etc.) are also at work

SESSION ONE

Introducing the main Macro Concepts needed
to analyse the influence of Macroeconomics
on Child Issues

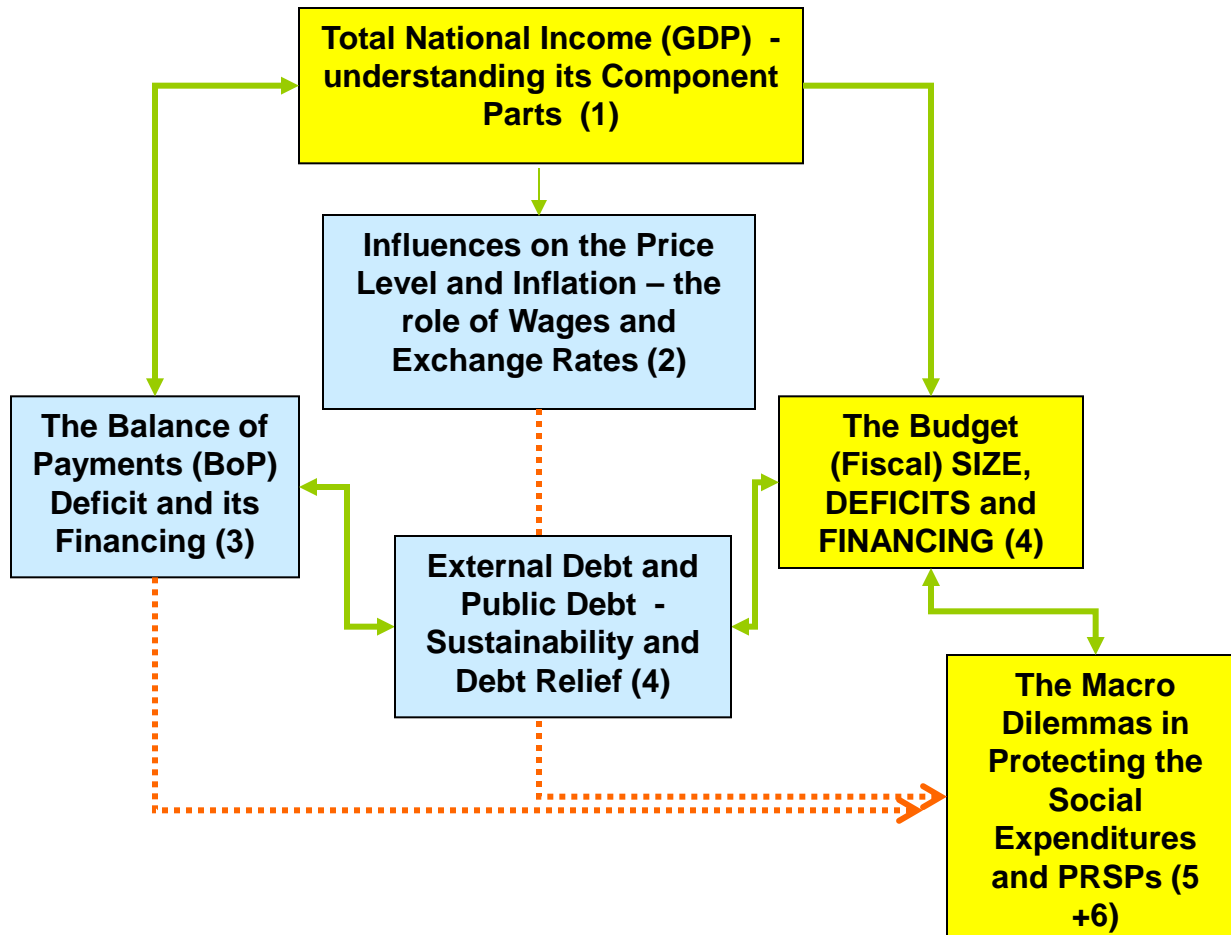
First – A notes about Macroeconomic Method

- Macroeconomics involves a comprehensive analysis of many inter-connected aspects of an economy – growth, inflation, government budgets, employment, trade, exchange rates etc
- We need to simplify the (often mind-boggling) relationships between these if we are to make any sense at all about what is happening
- These simplifications are often referred to as “models” and use various degrees of algebraic formulations to study critical interactions
- Today we will almost completely the AVOID the use of models. The key concepts will be illustrated with words and tables. Some limited algebra is provided (as an OPTIONAL EXTRA ONLY) mainly in the *Notes Pages*.

The Topics we will Consider

1. Total National Income (GDP) – understanding its components
2. Influences on the Price Level –Wages and Exchange Rates – and how these relate to the Poverty agenda
3. Explaining why poor countries face such pressures and macro INSTABILITY from – the Balance of Payments (BOP) and Fiscal deficits
4. Financing limits on the BOP and (mainly) the Fiscal Deficits
 - What AID can and cannot do?
 - External and Public Debts – Sustainability and Debt Relief?
5. IN SESSION TWO - Bringing it together – how the Macroeconomic nexus can impact Social Agendas in Government Budgets – Uganda example.
6. FINALLY – taking stock of a few Generic Issues of relevance to the UNICEF agenda

BUT Time is Limited so let's FOCUS



Topic 1: The Main Aggregates

First **TOTAL PRODUCTION** (or Gross Domestic Product - GDP)
Merely the sum of everything the country produces:

$$GDP(Y) = Pr_{agriculture} + Pr_{oil, gas, etc} + Pr_{industry} + Pr_{services}.....[1]$$

But TOTAL GDP (value-added) in the poor countries in which we are mainly interested is very small – see Data on Next Slide:

- \$580 on average
- Equivalent to ONLY 2% of that of High-Income Countries
- So for the SAME percentage utilisation of GDP on Children (education, health care etc) the Poor Country gets on average only 2% of what a High-Income country would get.

World Incomes in 2005

Absolute Numbers

	No. of Countries	No. of People (million)	Total GNI ER basis \$ billion.	Per capita GNI ER basis \$US
Low Income	59	2,353	1,363	580
Lower Middle-Income	54	2,475	4,878	1918
Upper Middle-Income	40	599	3,579	5625
High Income (of which OECD Members)	56	1,011	34,524	35131
	24			
TOTAL - WORLD	209	6,438	44,318	6987

Readings:

Some of you may wish to read more about the definitions of GDP and how it can be added up in different ways to tell us different things about the TOTAL income and capacities of a country. You will be provided with a section of a forthcoming textbook IF you want to read more fully on this

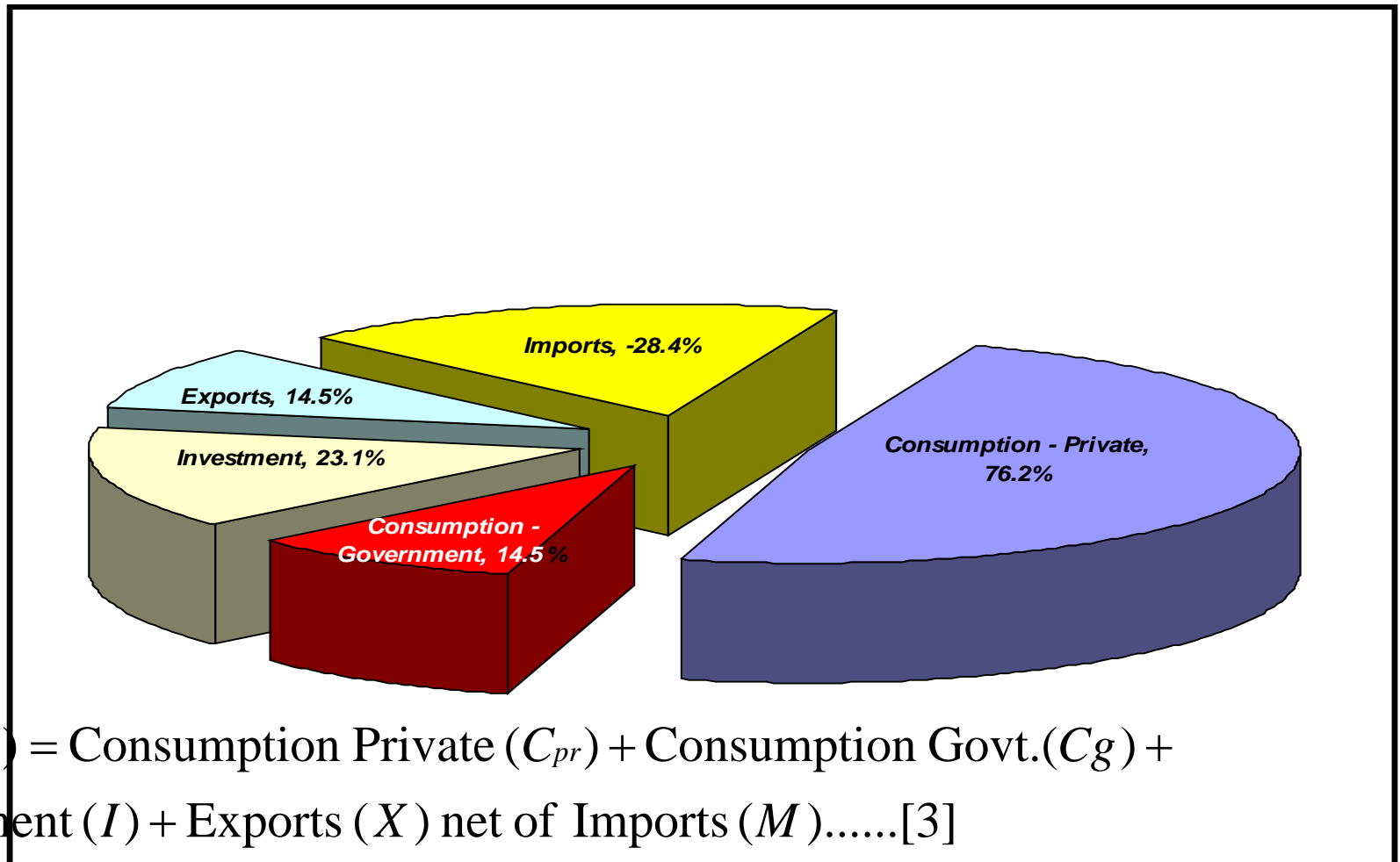
Alan Roe and Miguel de Freitas, *Modern Development Economics*, Chapter 3 (selection)

Here's an Example for One Poor Country – Uganda's GDP (Value-Added)

	2002/03	2003/04	2004/05	2005/06	2006/07
Value Added (bn 2000 Ush)					
Agriculture	3,435	3,499	3,939	3,941	3,952
Manufacturing	986	1,027	1,143	1,145	1,207
Construction	988	1,114	1,189	1,339	1,456
Trade, hotels	1,477	1,581	1,735	1,845	1,970
Transport & comm.	683	824	999	1,187	1,443
Community services	2,295	2,418	2,536	2,765	2,816
of which health	262	283	319	371	415
education	702	761	811	890	946
Other	646	670	704	688	702
Total	10,510	11,133	12,245	12,910	13,546

Source: Uganda Bureau of Statistics (UBOS) website, adjusted by IMF CPI

How Does Uganda USE this Total Production?



Uganda - Expenditure tables

	2002/03	2003/04	2004/05	2005/06	2006/07
Expenditure (bn Ush 2000 prices)					
Consumption					
Private	8,443	9,234	9,497	10,061	11,361
Public	1,613	1,699	1,809	1,921	2,046
Investment & stocks					
Private	1,653	2,028	2,235	2,447	2,851
Public	518	554	619	608	642
+ Exports	1,230	1,496	1,658	1,916	1,780
- Imports	2,797	3,179	3,399	3,750	4,551
Total	10,660	11,833	12,419	13,203	14,129

Source: UBOS

The Twin Financing Gaps

A. The External (Current) Deficit

A CAB deficit implies (BY DEFINITION) that consumption and investment together are greater than production

	2002/03	2003/04	2004/05	2005/06	2006/07
Production and Expenditure (bn Ush 2000 prices)					
Production (VA)	10,510	11,133	12,245	12,910	13,546
Consumption	10,056	10,933	11,306	11,982	13,408
Investment	2,171	2,583	2,854	3,055	3,493
Current Account Balance	-1,717	-2,383	-1,915	-2,126	-3,354

- Notice that Uganda's TOTAL Consumption is almost equal to its TOTAL Production. So most investment spending must come from running an External Deficit (which has to be financed)
- But most Consumption is PRIVATE – so the part left over for **ALL PUBLIC CURRENT SPENDING** is very small (i.e. 2,046 in 2006/7)

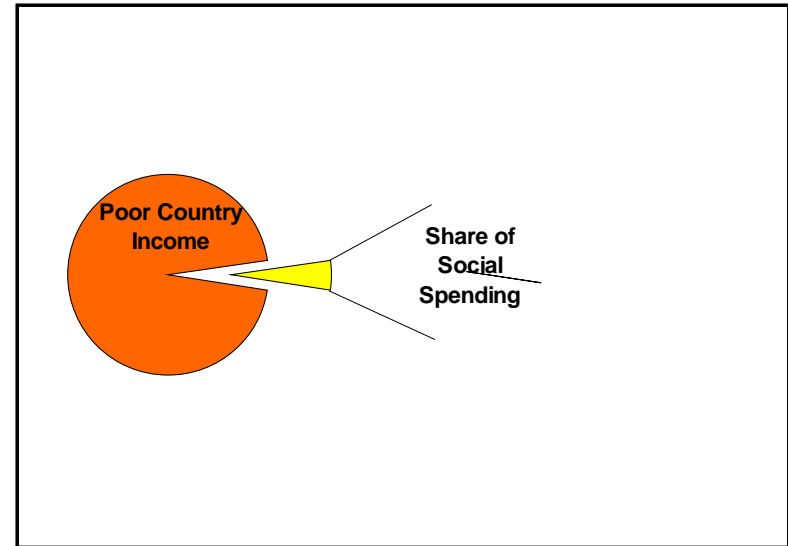
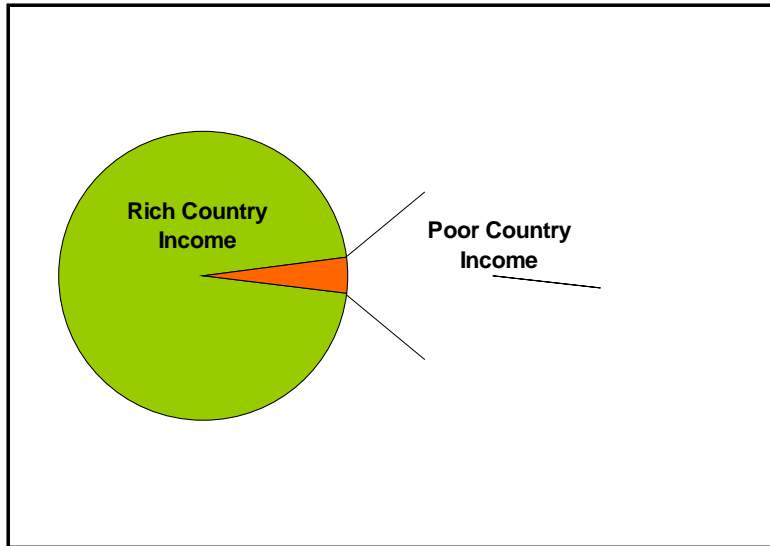
Data - Low Public Spending in Poor Countries

(Source: UNDP, Human Development

Report, 2006) — Remember GDP itself may be only 2% of the rich country figure

	<i>Education (% of GDP)</i>	<i>Health (% of GDP)</i>	<i>Military (% of GDP)</i>	<i>Debt Service (% of GDP)</i>
Lesotho	9.0	4.1	2.3	4.0
Kenya	7.0	1.7	1.6	2.3
Bangladesh	2.2	1.1	1.2	1.2
Mauritania	3.4	3.2	1.4	3.7
Rwanda	Na	1.6	2.2	1.3
Nigeria	1.0	1.3	1.0	3.3
Burundi	5.2	0.7	6.3	13.4
Angola	na	2.4	4.2	10.5
HIGH HDI Countries	2-8%	2-8%	0-5%	0-17%

Two Small Numbers do not make a BIG One – unfortunately !!!



B. What about the Savings Gap

National Savings (S) are defined as production less consumption.

	2002/03	2003/04	2004/05	2005/06	2006/07
Savings Gap					
Production	10,510	11,133	12,245	12,910	13,546
- Consumption	10,056	10,933	11,306	11,982	13,408
= Savings	454	200	939	929	139
- Current Account Balance	-1,567	-1,682	-1,741	-1,834	-2,772
= Investment	2,171	2,583	2,854	3,055	3,493
error	-150	-700	-174	-292	-583

Because SAVINGS in Uganda are very low, we see again that INVESTMENT (in schools, roads etc but also in the productive economy) relies on the use of savings from abroad.

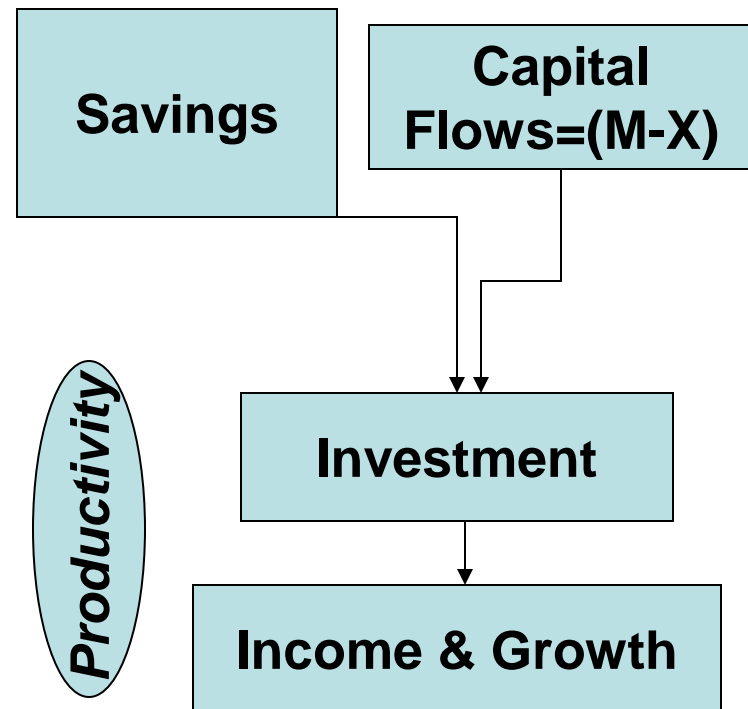
A 2 Minute Question Break

From what you have just heard explain why an ending of agricultural subsidies by rich countries (a central theme of the Doha WTO negotiations) might initially REDUCE living standards in the poorer countries that are the main beneficiaries of this reform.

Remember that (i) GDP cannot change much in the short term and (ii) increased EXPORTS take resources away from CONSUMPTION (Private or Government).

...continued

- In the early days of Development Economics it used to be argued that INVESTMENT levels were the critical determinant of a poor country's rate of growth.
- Further if the SAVINGS rate was too low to achieve the necessary rate of INVESTMENT then FOREIGN AID transfers or other capital flows would and should fill the gap.
- This idea is illustrated on the graphic on the right
- The evidence from the next two slides enable us to debate this idea



Aid Flows to Poor Countries – 2004 *(note the lack of any inevitable impact of Aid receipts on the levels of social spending)*

	<i>Education (% of GDP)</i>	<i>Health (% of GDP)</i>	<i>AID Disbursed (% of GDP)</i>	<i>Debt Service (% of GDP)</i>
Lesotho	9.0	4.1	7.8	4.0
Kenya	7.0	1.7	3.9	2.3
Bangladesh	2.2	1.1	1.2	1.2
Mauritania	3.4	3.2	11.7	3.7
Rwanda	Na	1.6	25.3	1.3
Nigeria	1.0	1.3	0.8	3.3
Burundi	5.2	0.7	53.4	13.4
Angola	na	2.4	5.9	10.5
Zambia	2.8	2.8	20.0	7.9

Zambia 1960 to 1993: note the complete lack of ANY real impact of Aid Flows on Income Levels in this one case (Source: W Easterly)

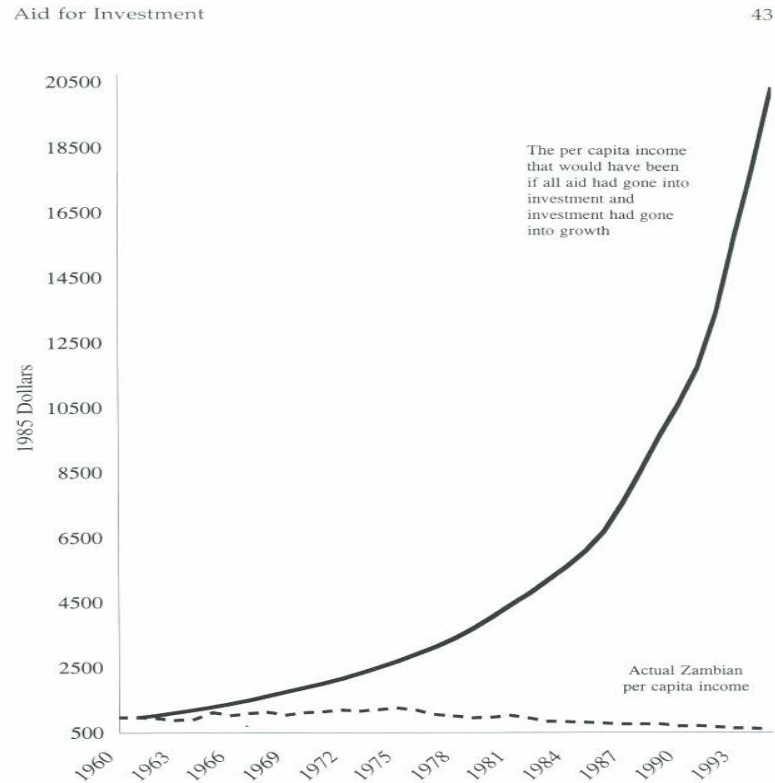


Figure 2.1
The gap between the financing gap model and the actual outcome in Zambia



Topic 2: Let's VERY Briefly Explore Prices

In a closed economy – one with no foreign trade, the price level will largely depend on the behaviour of (i) wages and (ii) labour productivity.

WHY?

The Notes provide a fuller answer just for those who need it. But in BRIEF and by numerical example:

- If GDP (Y) and the labour force (L) were both rising at the same rate (say 5%) then labour productivity would NOT be changing and prices would rise broadly in line with average wage rates.
- for example, an 8% wage increase would likely cause prices also to rise by about 8%.
- But if Y grew at 5% versus only 3% for L then labour productivity would be rising at 2% per annum and wages could rise by that 2% WITHOUT giving rise to any price rises. So an 8% wage increase could result in only a 6% increase in prices and there would be a 2% gain in the REAL incomes of workers = their productivity gain.

NOTE: in a mainly self-employed and partly subsistence economy, substitute the term “average incomes” for “wages in the above examples.

Prices in the Open Economy

In the case where the economy trades internationally and acquires a significant part of its total supplies as Imports (e.g. oil, other imported raw materials or consumer goods such as food and medicines), then the prices of these must also impact the domestic price level.

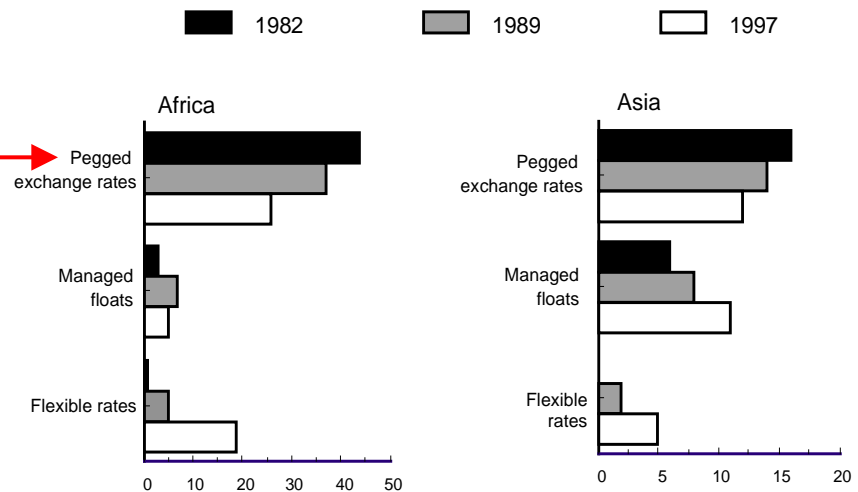
Now the price level has a DOMESTIC component driven by wage rate changes and an IMPORTED component driven by foreign prices and MOST IMPORTANT by the Exchange Rate. :

So if the imports (of basic materials such as oil or consumer goods such as food) are large then changes in international prices of these items AND our exchange rate (e.g. the numbers of pesos or cedi we pay for each dollar) can have an important additional influence on prices and inflation.

The Nominal Exchange Rate and the Poverty agenda

- Partly because of the logic from the previous slide low income country governments have shown a traditional preference for **Fixed Exchange Rates**
- This may help protect (poor) people from one source of higher prices
- But it can be disastrous IF the domestic influences on prices are such as to push up **domestic prices** very fast – See next slide
- REASON. Poor people often CONSUME mainly domestic goods but partly PRODUCE goods that depend on the prices made possible by the INTERNATIONALLY Traded element of prices**

Figure 4.2a
Developing Countries: Exchange Rate Arrangements 1/
(Number of countries)



Source: International Monetary Fund.

Note: Countries with *pegged exchange rates* are those countries classified by the IMF as pegged to a single currency, pegged to a basket of currencies or crawling peg. Countries with *managed floats* are those countries classified by the IMF as adjusting to a set of indicators and managed floating. Countries with *flexible rates* are the countries classified by the IMF as independently floating.

Example of a (fixed) ER Disaster

- Ghana in the 1970s (stylised)

	1974	1976	1978	1980
Cocoa Price \$ per tonne	100	100	100	100
Exchange Rate (cedi per \$)	1.15	1.15	1.15	2.75
Price to famers in cedi	115	115	115	275
Cost in Cedi	45			
Inflation Index	100	156	336.96	505.44
Cost in Cedi	45	70.2	151.632	227.448
Profit per tonne in cedi	70	44.8	-36.632	47.552

A 4 Minute Question Break

In 1979 -1980, some economists in Ghana started to argue that the economy and the livelihoods of poor households would only begin to improve if the authorities abandoned their (then) commitment to a fixed cedi:\$ exchange rate, even though this might raise the consumer prices of goods imported to Ghana.

In your own words explain this case based on what you have just heard.

TIP. Take a close look at the Ghana inflation rate during the period of the fixed ER in the light of Equation [10]. The experience of Zaire (next slide) with the parallel (black-market) exchange rate may also give a useful clue to what also happened in Ghana

Topic 3: Macro Instability

1 What do we mean by “Instability”?

ANSWER – it comprises some of....

- high and variable price inflation (including exchange rates)
- erratic but often negative GDP growth rates
- unsustainable levels of debt that finance fiscal and external deficits which have to be reduced (eventually)

2. Why does Instability hurt the poor?

ANSWERS include

- Inflation is a regressive tax that falls disproportionately on those holding cash rather than interest earning assets
- Instability tends to cause lower output growth longer term and this impacts directly on the poor via direct impacts on incomes but also on human capital – school enrolment rates, drop out rates etc.

Why UNICEF should be concerned about macroeconomic crisis/ instability ?

Macroeconomic crises /instability

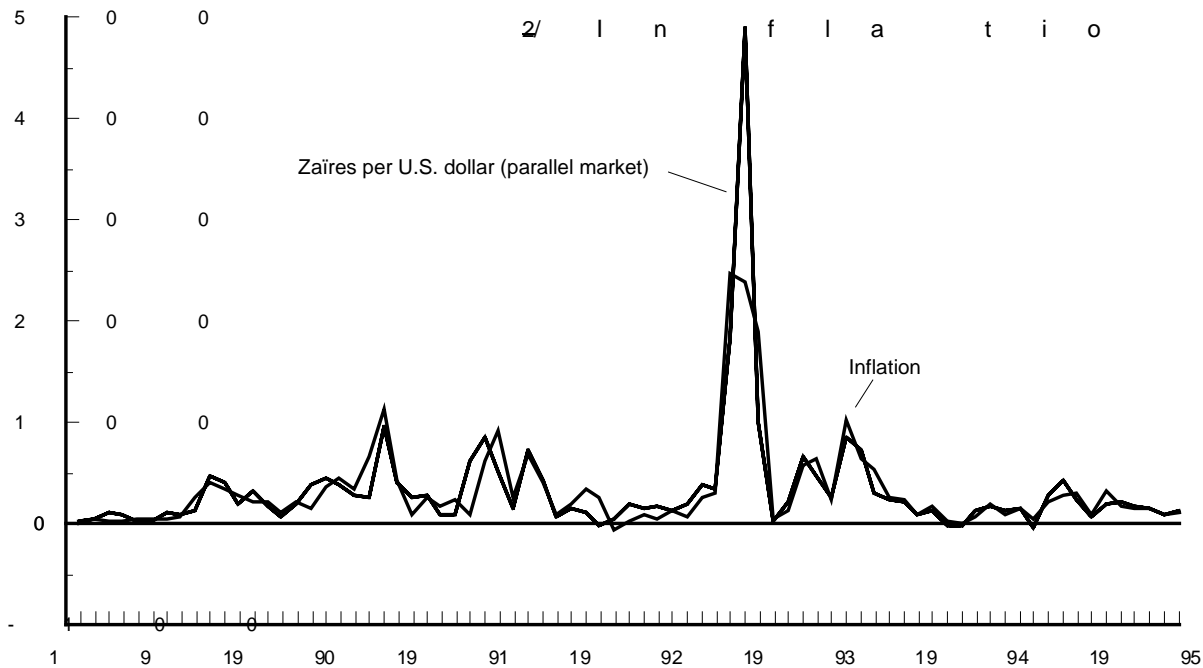
Can ruin family stability and service provision by:

- Stagnation or recession propelling unemployment and falls in (already low) public revenues
- Exchange rate devaluation pushing up inflation, increasing foreign debt burden in national currency and increasing the costs of vital social expenditures
- Inflation can undermine wages and households savings
- Austerity budgets measures(the frequent unavoidable response to a crisis) entail cuts in public services and/or in their financing

→ Note: social unrest and/or unsustainable coping strategies from private and public sector actors could further deepen the crisis and its impact

Zaire: An extreme example of instability

Figure 5.1b
Zaire: Inflation and Exchange Rate Depreciation, 1990-96



Source: Beaugrand (1997).

2/ Parallel exchange rate in terms of old zaïres. The new zaïre was introduced in October 1993 at a parity of NZ=Z 3,000,000; later data have been rescaled accordingly.

Sources of Macro Instability (1)

The Balance of Payments

In order to see how the Twin deficits fit together with other parts of the macro-economy to cause instability, we first need to disaggregate a few of the aggregates already examined in Topic 1

This is done for the GOVERNMENT sector, the PRIVATE sector and the REST OF THE WORLD (“Foreign”) in a tabular format in the next slide

BUT we want to focus mainly in the GOVERNMENT balance (row 1 and column 2) since this is our link to anti-poverty and other social expenditures and the constraints on these.

The Key Aggregate Identities

	Private Sector (firms/people)	Government (centre/local/parast.)	Foreign (govts/firms/people)	Total
Goods & Services	Private savings balance	Government savings balance	Current account balance	zero
	<i>used for</i>	<i>financed by</i>	<i>financed by</i>	
Non-Monetary Financial Assets	Change in private assets/debts	Change in govt assets/debt	Net capital flow	zero
	<i>and</i>	<i>and</i>	<i>and</i>	
Monetary Assets	Change in private money/credit	Change in govt domestic credit	Change in foreign reserves	zero
Totals	zero	zero	zero	

A Numerical Example

Using the various data sources presented earlier, an estimate of the matrix for Uganda is as follows

Uganda 2005/06 (in Ush bn)

	Private	Government	Foreign	Total
Goods/services	575	-1,276	701	0
Non-Monetary	-272	1,403	-1,159	-28
Monetary	-303	-124	426	-1
Total	0	3	-32	-29

Reproducing the above matrix with real data (as here) is often tricky because the source data comes from various sources which are rarely fully reconciled. This is why the Rows and Columns shown here fail to add to ZERO as they should.

Components of the BoP

The previous slide shows (in Col 3) – the THREE components of the BoP. Note that these must always sum to zero.

These components are:

- The Current Account
- The Capital Account (Non-Monetary)
- The Monetary or Reserves Account

Note also from row 1 of the previous slide that:

- high Government expenditure relative to tax revenues (resulting in the deficit of Ush 1,276) has a direct impact on the size of Uganda's BoP current deficit and so on the EXTERNAL borrowing that the country needs to make
- It does NOT JUST affect the need for the government to raise money to finance is OWN deficit.

Typical BoP Table (to note only and study later)

	millions of US\$						
	2004/05	2005/06	2006/07		2007/08	2008/09	2009/10
	Act.	Act.	Prog.	Proj.	Proj.	Proj.	Proj.
Current account	-183	-384	-581	-279	-846	-1,039	-1116
Trade balance	-838	-1,102	-1,278	-1,197	-1,631	-1,801	-2065
Exports, f.o.b.	786	890	1,029	1,180	1,270	1,360	1470
<i>Of which: coffee</i>	145	173	206	227	231	242	256
Imports, f.o.b.	-1,624	-1,991	-2,307	-2,377	-2,900	-3,162	-3535
<i>Of which: oil</i>	-158	-290	-358	-381	-428	-471	-506
Services (net)	-320	-384	-383	-433	-482	-517	-437
Income (net)	-168	-135	-133	-119	-156	-203	-184
<i>Of which: interest on public det</i>	-38	-36	-18	-22	-30	-31	-33
Transfers	1,143	1,237	1,213	1,470	1,423	1,482	1570
Private transfers	401	687	497	798	879	966	1074
<i>Of which: nongovernmental c</i>	248	530	333	515	566	623	685
Official transfers	742	550	715	672	544	516	496
<i>Of which: Budget support</i>	402	184	336	352	232	220	199
Project support	223	232	295	252	255	237	237
HIPC grants	81	81	45	51	45	43	44
Capital and financial account	324	635	775	452	937	1,216	935
Capital account	0	125	3,053	3,053	0	0	0
<i>Of which: MDRI debt relief</i>	0	125	3,053	3,053	0	0	0
Financial account	324	509	-2,278	-2,601	937	1,216	935
Foreign direct and portfolio inve	235	257	312	322	431	614	700
Other investment	89	252	-2,590	-2,923	506	603	235
Medium- and long-term	69	184	-2,702	-2,718	602	564	509
<i>Of which:</i>							
Public sector (net)	71	174	-2,712	-2,728	479	457	309
Disbursements	164	255	408	387	541	518	373
Project support	158	214	256	242	356	409	263
Budget support	6	42	152	220	110	110	110
Amortization due	-93	-82	-3,120	-3,115	-62	-62	-64
Private sector (net)	-2	10	10	10	123	108	201
Short-term	20	68	112	-205	-96	38	-274
Errors and omissions	99	3	0	0	0	0	0
Overall balance	240	254	194	172	91	177	-180
Financing	-240	-254	-194	-172	-91	-177	180
Central bank net reserves (increa	-242	-228	-169	-149	-66	-155	197
<i>Of which: gross reserve change</i>	-191	-83	-169	-149	-66	-155	198

Adjusting a BoP Deficit – a major cause of unstable livelihoods

ANY country that persistently runs a large Current A/C deficit (X-M adjusted for the other current flows such as foreign aid would NORMALLY HAVE TO ADJUST through a combination of policies to:

- Deflate incomes (via tighter fiscal and monetary policies or direct income restraints) to reduce the imports consumed or used for investment. This is called the *Expenditure Reduction* approach.
- Switch a part of total demand away from C+I+G and into exports (via exchange rate devaluation, direct subsidies) to make possible increased export earnings. This is referred to as the *Expenditure Switching* approach.

In practice both approaches will harm living standards and for this reason governments are frequently reluctant to make the adjustments (at all) or they adopt them with insufficient commitment.

Avoiding the adjustment

Examples:

The adding in that comes from the matrix in Slide 32 makes it clear that a deficit in the Current Account can be sustained over time IF a country can call on a SUSTAINABLE flow of capital into the economy (i.e., the Capital Account is in sustainable surplus).

The real problem for policy is knowing what is or is not SUSTAINABLE

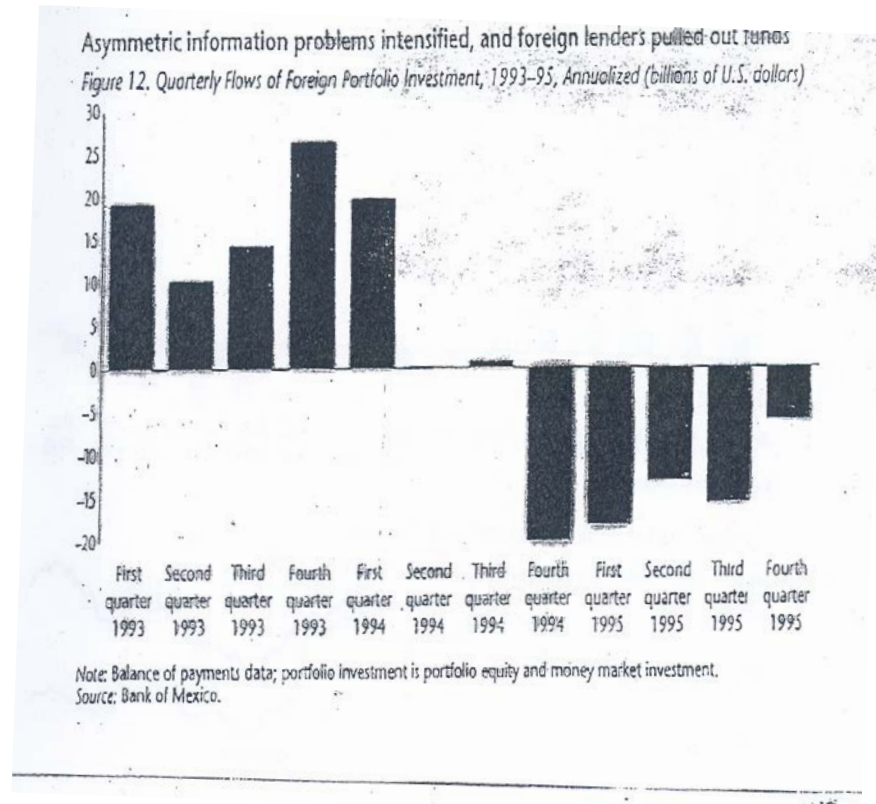
- Developing countries as a whole in the period 1973 to 1981 were able to avoid the large BoP adjustment necessitated by much higher oil prices because they were able to borrow large amounts of so-called petro-dollars through Western banks. But this was not SUSTAINABLE – in 1982 when Mexico defaulted on her debt, the flows dried up and many developing countries needed to make the BoP adjustments that had been avoided until that date.
- The USA has for many years been running huge Current A/C deficits (now >5% of GDP) but has also been able to borrow heavily from countries like Japan and China who are prepared to buy US Treasury and other securities (so far!).

A 2 Minute Question Break

Examine the data showing foreign capital inflows into and out of Mexico in the period 1993 to 1994. Should Mexican policy makers have adjusted their BoP before the Dec 1994 crisis?

What do you imagine were the consequences of failing to do so?

Note: in 1993, the inflows of capital at >\$20 billion per annum represented around one fifth of all such transfers to developing countries!



The Special case of the HIPC

- The 41 HIPC countries do not have external debts that are particularly large in absolute terms (see next slide).
- But relative to their available resources for servicing these debts (e.g. export earnings) the debts have proved unsustainably high
- Before the HIPC debt relief initiative was launched in 1996, this resulted in frequent failures by these countries to pay the amounts due on these debts in a timely manner
- So building debts of various kinds – that were then NOT serviced - became one significant way for these poorer countries of dealing with their BoP deficits
- An intensified dependence on concessional but highly-conditional debt is one evident consequence seen in the record of the past 20 years (*see Notes page and slides 32 and 33*)

The External Debt of (i) All Developing and (ii) Poorer Developing Countries

Public External Debt Outstanding (Amounts in \$ million)	1990	2000	2001	2002	2003	2004
All Developing Countries						
Debt outstanding (LDOD), total long-term (US\$)	1,098,884	1,909,082	1,868,399	1,925,638	2,054,118	2,164,919
PNG, total private nonguaranteed (DOD, US\$)	59,996	545,210	542,731	551,384	603,082	671,482
Low Income Countries Only						
Debt outstanding (LDOD), total long-term (US\$)	285,169	330,151	321,926	341,485	370,088	379,869
PNG, total private nonguaranteed (DOD, US\$)	7,692	25,533	24,705	26,757	29,739	33,678

The Changing Composition of HIPC Debt

Source: W. Easterly in *World Development*, 2002

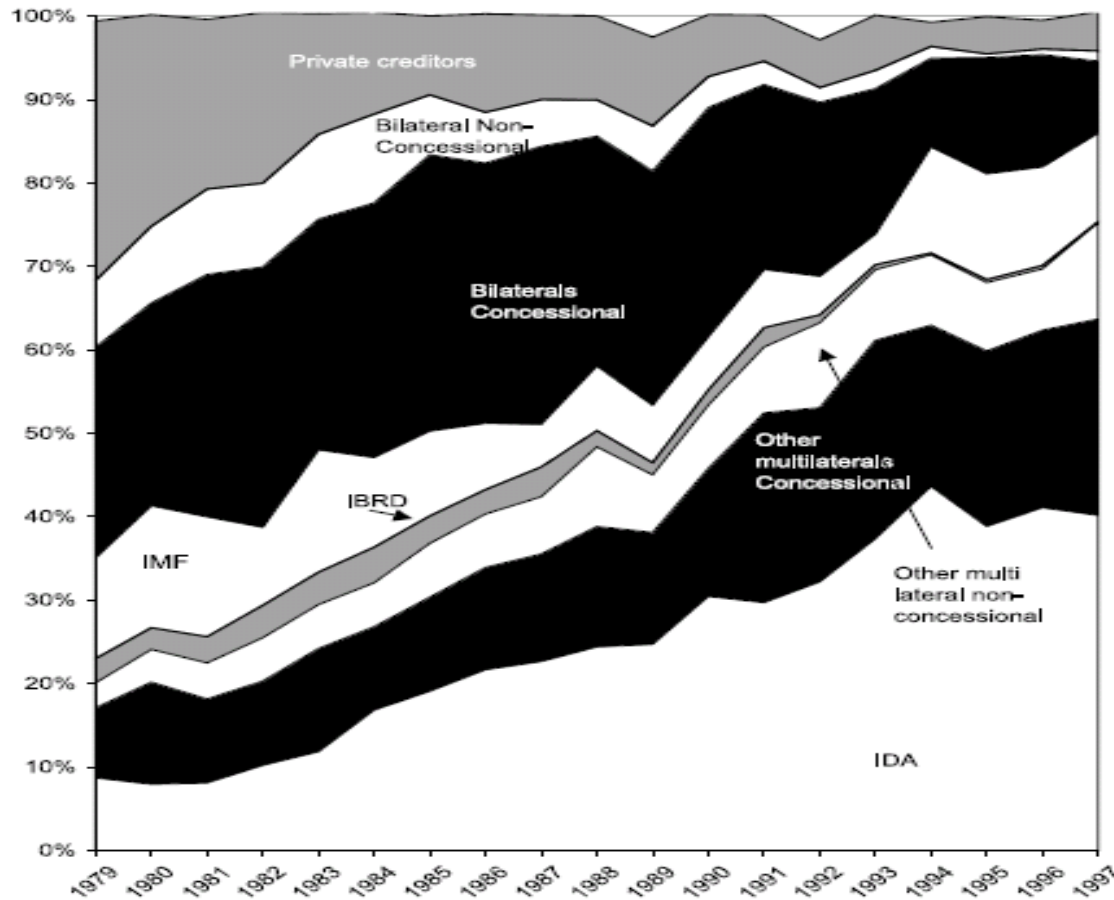
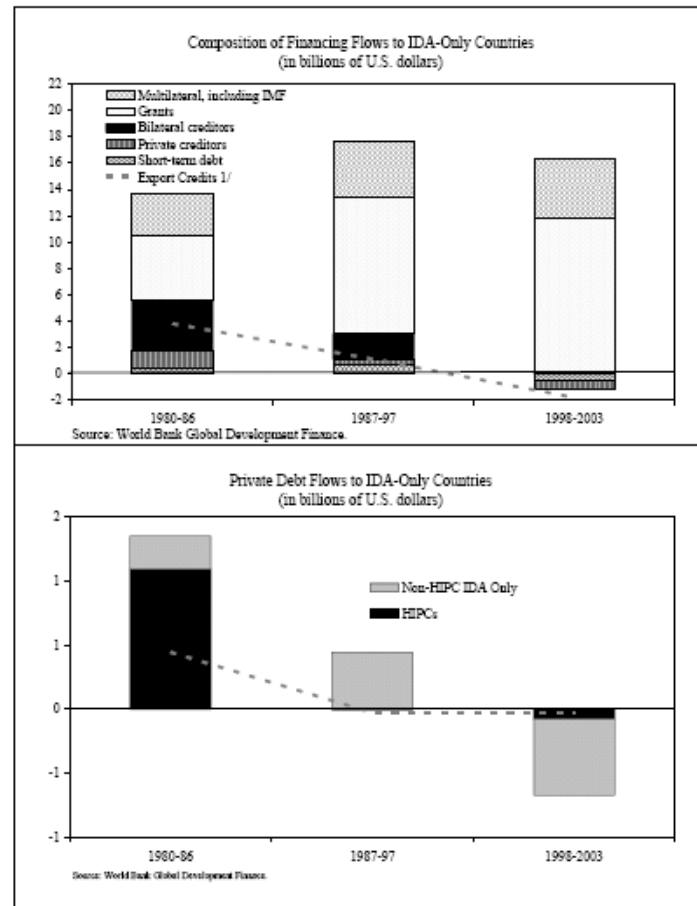


Figure 5. *Composition of gross disbursements to HIPC countries.*

A Similar Story with the Flows of new Borrowing



Topic 4: Sources of Instability (2)

The Fiscal Deficit

There are various alternative views of the “fiscal deficit”:

- The conventional (IMF - GFS) definition is:
Overall Deficit/Surplus = (Revenue (taxes and fees) + Grants) – (Expenditures (current and capital) + Lending net of repayments) – on an accrual basis.
- The *Primary Deficit* is the same except that Expenditures are measured by excluding all interest payments on debt to get a truer picture of the benefits to the economy coming from public spending. Low-income countries that have significant debt problems (either domestic debt or international debt) can easily have an Overall Deficit much larger than the Primary Deficit (e.g. Kenya in 1993)

The other main variants are:

- A CASH or a COMMITMENTS basis for measuring expenditures or receipts?
- Include or exclude foreign grants?

Global Trends: How Big are Fiscal Deficits?

	Revenue (% of GDP)		Expenditure (% of GDP)		Overall Deficit (including grants) (% of GDP)		
	1990	1998	1990	1998	1990	1998	2004
World	22.5	26.4	25.8	27.9	-3.0	-1.5	
Low income	15.5	13.9	18.3	17.0	-4.8	-4.0	-3.3
Middle income	17.4	19.1	21.5	20.5	-2.5	-3.0	
Lower middle income	12.7	14.2	15.3	18.8	-1.5	-4.0	
Upper middle income	20.4	22.2	25.5	22.8	-3.1	-3.5	
Low & middle income	17.1	18.6	21.1	20.1	-2.8	-3.1	
East Asia & Pacific	13.2	10.1	14.4	13.2	-0.8	-3.0	-2.1
Europe & Central Asia	..	25.0	..	30.8	..	-4.7	-1.3
Latin America & Carib.	18.8	20.1	25.5	21.0	-3.5	-4.2	
Middle East & N. Africa	
South Asia	13.8	12.4	17.6	16.3	-7.3	-5.1	-3.1
Sub-Saharan Africa	24.0	..	27.7	..	-3.5	..	
High income	23.9	28.7	27.0	30.2	-3.0	-1.1	-2.8
Europe EMU	34.7	37.1	38.6	40.0	-3.7	-2.3	-2.2
Source: WDI							



Why do Fiscal Deficits Matter?

Answer 1: In low-income countries fiscal deficits are prone to be quite high and to be financed by “printing money”

- Because both tax administration and capital markets, are relatively underdeveloped
- So governments often have no option but to monetize deficits i.e. borrow from the central banks – “print money” to finance these deficits

Answer 2: Monetary growth can have strong effects on INFLATION – a key UNICEF concern regarding poor persons) by stoking the demand for real goods & services that can drive up prices and wages – see also the Notes page to Slide 16 – especially where financial sectors are small.

- High inflation in turn can negatively impact economic growth
Michael Bruno and William Easterly, *Journal of Monetary Economics* 41,(1998)

How are Deficits Financed?

There are always THREE main ways to finance a deficit:

:

1. Printing Money – i.e. an enforced credit creation where the funds flow to the government (via borrowing from Central Bank)

2. Voluntary DOMESTIC Borrowing

3. INTERNATIONAL Borrowing

And 4. a Fourth Messy way – arrears, non-payment of bills, forced sales of government securities on local banks etc

We next consider the limits of each of these methods in turn

Further Explanations:

Some of you may welcome more fully argued explanations of what follows next. These explanations can be found in the *Notes Pages* together with some algebraic explanations of the propositions on slides 47 to 58 inclusive

Method 1: “Printing” Money – the Constraints

Let us establish **TWO** very important propositions:

1. The authorities can only successfully finance their deficits by printing more money **IF** the public are willing to hold higher money balances. If the authorities print **MORE** money than the public wish to hold then the surplus money will quickly dissipate in an attempt to buy goods including imported goods. This will have a direct *positive* effect on domestic inflation and/or a *negative* effect on the BoP and the level of foreign reserves.
2. The public’s willingness to hold money is dependent on factors such as income level (Y), prices (P) and interest rates (indicating the attractiveness of non-money assets). But it is also critically dependent on previous experience (e.g. if recent experience as in Zimbabwe indicates that prices will rise very rapidly then **NO ONE** will voluntarily hold extra units of domestic money when it is put into circulation).

A Numerical Example

This case assumes a Fixed Exchange Rate which helps to keep down the rate of inflation associated with any excessive printing of money. But that excess then needs to find its outlet in the purchase of imported goods. Assuming to make the point that the inflation effects are in fact ZERO

Money Supply = Total Domestic Credit + Foreign Reserves (NFA)

see Notes to Slides 47 and 48

Foreign Reserves (NFA)	=	3 Months Imports
Imports	=	24% GDP
So Foreign Reserves	=	6% GDP

These numbers are not unrealistic for a typical low-income developing economy. Although the reserves level is high for some countries. African deficits through the 1980s averaged around 6-7% GDP

The implication is that fiscal deficits at this level could exhaust foreign reserves in one year or less.

How Much Inflation might be required

To answer this question – in the more general case - consider (realistically) TWO elements in the public's demand to hold money

Specifically:

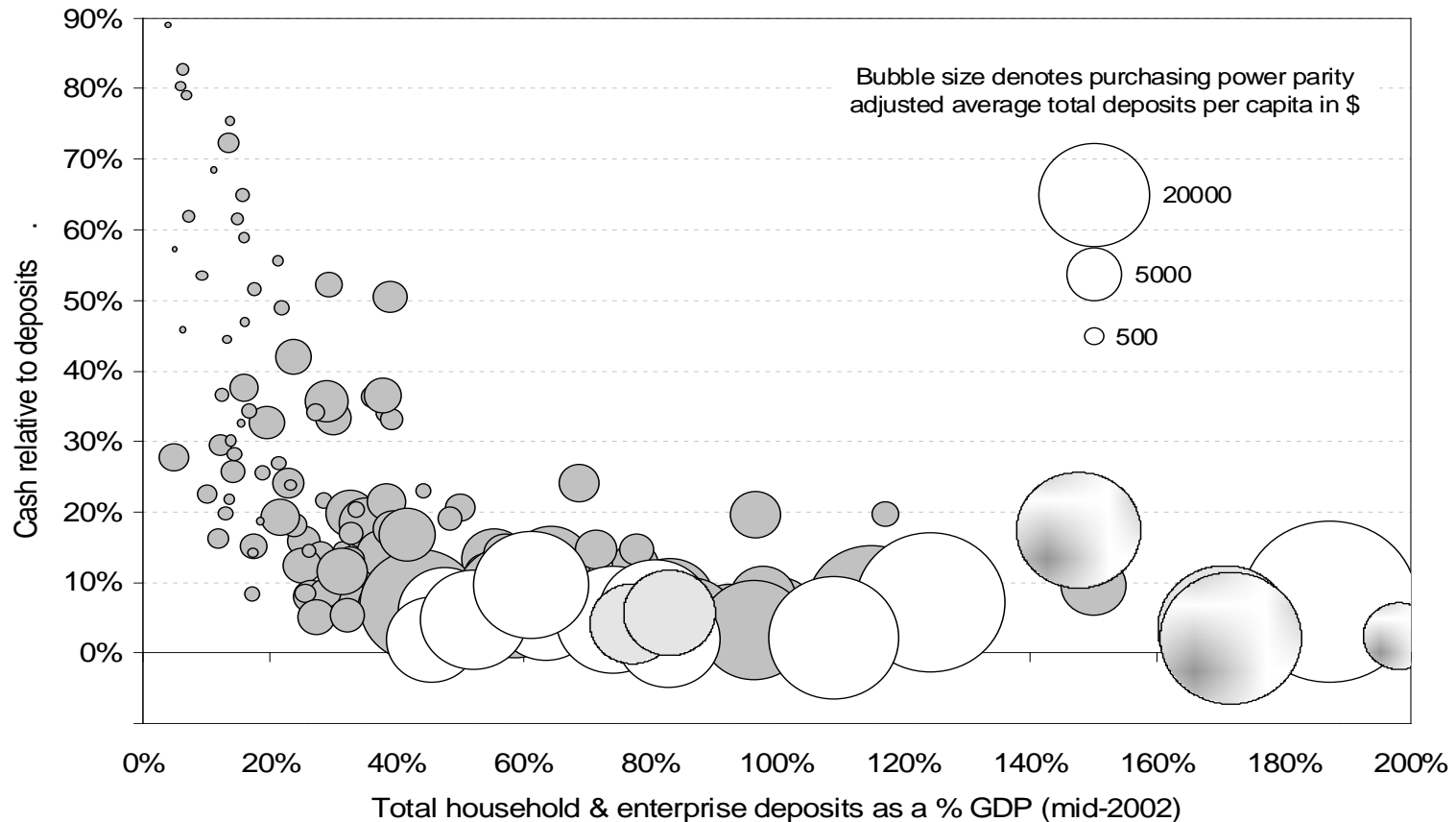
- a stable element that defines normal conditions and a normal willingness to hold money (call this α)
- an inflation element that reflects people's well known tendency to reduce their money holdings as inflation rises higher and higher – e.g. as in Zimbabwe today (call this β).

Numerical Example *(Y growth = 1% and the fiscal deficit = 5% of GDP, β = zero initially (last row) but rises with inflation, inflation rate required = π ,*

Beta gradually rising							Monetary
$1/\alpha$	α	β	g	y	π	depth- Eq [9]	
0.05	20.00	15	0.05	0.01	396.0%	1.3%	
0.15	6.67	9	0.05	0.01	58.8%	8.4%	
0.2	5.00	8	0.05	0.01	40.0%	12.2%	
0.3	3.33	6	0.05	0.01	22.4%	21.4%	
0.35	2.86	5	0.05	0.01	17.7%	26.7%	
0.45	2.22	3	0.05	0.01	11.9%	38.8%	
0.5	2.00	2	0.05	0.01	10.0%	45.5%	
0.6	1.67	0.5	0.05	0.01	7.5%	58.7%	
1	1.00	0	0.05	0.01	4.0%	100.0%	

Notice how even a (low) 5% deficit can promote seriously high inflation when the β value is high and combines with an already low degree of (normal) monetary depth (column 1). Most countries of concern to us are in the 0.1 - 0.2 range in column (1) – see next slide.

Unfortunately most low-income countries have very low levels of financial depth (values for α)



Method 2: Local Borrowing – the Constraints

For any any given level of the PRIMARY Deficit (i.e. the deficit ignoring interest payments), increased use of local borrowing today results in lower inflation (π) today but also to a larger overall deficit in future see *Notes pages for the algebraic logic*.

There are TWO main constraints on such borrowing:

1. Local financial markets (banks, insurance companies etc) are typically very SMALL - so there is little capacity to absorb (buy) new government debt issues:
2. The demand to buy government debt in those markets is typically unresponsive to higher interest rates. So quite HIGH interest rates may be needed to sell a relatively moderate volume of new government debt.

How do the Constraints work out in practice?

- IF the (real) interest rate accruing on government debt EXCEEDS the growth rate of government revenues, the **ratio** of debt service to total government revenues) will rise. Such an inequality is acceptable only for BRIEF periods.
- But note that attempts to issue significantly large amounts of debt confronts point 2 (previous slide) to increase the likelihood that the volume of debt will rise uncontrollably by pushing the interest rates ABOVE the rate of growth of revenues.

Low income countries have frequently exceeded both their domestic and their external borrowing capacities and so have achieved some short-term help for the financing of fiscal deficits – **and lower inflation** - only at the expense of more difficult problems of this type at a later stage.

Note the example of Kenya in 1991-1992 when interest rates were liberalised (temporarily) as an illustration of these very real problems (next slide)

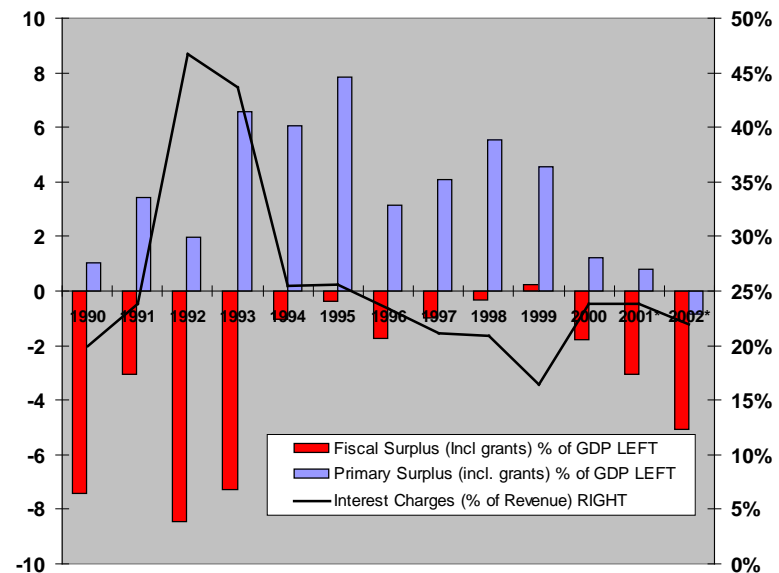
An Example of seriously Unsustainable LOCAL Borrowing: Kenya in 1992/93

In this case when the authorities liberalised the financial markets in 1991/92, government interest payments (mainly on domestic debt) became very large in spite of a reasonably healthy *primary* budget position.

In essence these interest charges increased much faster than the growth of the budget revenues that were needed to pay the interest charges

So they quickly came to represent an unsustainably high proportion of such revenues.

Chart 2: Kenya - Fiscal Balances and Interest Payments



Method 3: Foreign Borrowing – the Constraints

If YOU personally, a COUNTRY or a GOVERNMENT is going to borrow money, the amount that you (they) can SUSTAINABLY borrow will depend on two things namely:

- the interest rate (in real – inflation adjusted - terms) that is charged while the loan is outstanding ($r-\pi$), i.e. how many real resources (such as potential food imports or new school buildings) do you have to give up to pay your debt charges? and
- the rate at which the income stream that will be used to repay the debt is increasing also in real-inflation adjusted terms (Y_{gr}). i.e. how rapidly are your available real resources (e.g. to buy food imports or to build new schools rising?).

For **fiscal (budget)** financing the relevant Y_{gr} will be the growth of Government Revenues including grants. For **external (BoP)** borrowing the relevant Y_{gr} term will be the growth of Export Earnings and associated foreign currency incomes (such as Remittances).

The Influences/Constraints on the External Debt ratio

(Source: S. van Wijnbergen, in *World Bank Economic Review*, Vol 3 No 3, 1989/90)

This looks at the indebtedness of the COUNTRY. Similar analysis can be applied to the indebtedness of GOVERNMENT.

He shows that a **sustainable** debt ratio (Debt divided by GDP) requires an appropriate combination of the following variables:

1. a higher real interest rate is bad – this raises the debt ratio for any *given* level of borrowing (i.e. the same logic as for the LOCAL borrowing)
2. a high **growth rate** of income (GDP) = n is good because it lowers the debt **ratio**. Again this is parallel to the effect of the growth of govt revenues in the local borrowing constraints
3. a non-interest current account BoP **surplus** is good – this can help to achieve some repayments
4. a depreciation of the real exchange rate is bad because it raises the real resources you need to find to service any given level of dollar debt

The last two points represent the main differences between foreign as compared to local borrowing.

Consider some of the Trade-Offs that arise - examples

1. A highly indebted country decides to reduce debt by running a significant BOP surplus (point 3 from the previous slide). But the fiscal austerity to achieve this surplus drastically reduces the growth rate of GDP and this worsens the countries debt ratio (because of point 2 from the previous slide) Example: Latin America in the 1980s
2. Instead the BOP and debt ratio improvement is sought by using a real exchange rate devaluation to boost growth through improved export earnings (relying on points 2 and 3 from the previous slide). This may work (Korea in the 1980s) but also creates a negative feedback effect on the debt ratio via point 4 from the previous slide. So if the export gain FAILS to materialise, this policy is very damaging for debt.
3. The authorities try to boost growth by simply spending more government resources on local goods and services. This may help the debt ratio via point 2 on the previous slide but only at the cost of a larger volume of new borrowing (and inflation) that is needed to finance the larger fiscal and BOP deficits.

Insights about Solvency emerge (the formula is given on the Notes Pages)

Countries with LOW initial debt ratios (“b”) to start with are more likely to be solvent

Countries with HIGH growth rates (“n”) are more likely to remain solvent

Countries with HIGH borrowing costs (“r^{\$}-P^{\$}”) will find it less easy to remain solvent

Example: IF $b=50\%$; $r^{\$}-P^{\$}=8\%$; $n=6\%$

Solvency requires a non interest BoP (NICA) > 1% of GDP

One can easily experiment with different values of the parameters to see how the demands of solvency increase reduce/

NOTE that HIPC countries typically have high values for “b” and low values for “n”. So although their borrowing costs ($r^{\$}-P^{\$}$) may be low – lots of concessional debt and grants (see Slide XXX) - they still have huge problems in achieving solvency.

Method Four – Messy Finance of Deficits

A few examples:

1. Government fails to pay suppliers and so builds up local arrears of payment
2. Government forces banks to “invest” in low or zero yielding government securities
3. Government allows state enterprises (e.g. power companies) to charge excessively low prices but then fails to provide funds to cover the resulting losses
4. Government fails to pay over the contributions to Pension Funds that are deducted from civil service pay
5. Government maintains a dual exchange rate and requires some exporters to surrender foreign exchange at the more overvalued of the two rates for use in government purchasing

Main Points from Topic 4

1. Governments with weak financial systems and a Fixed Exchange Rate, will find that attempts to use monetary financing of deficits will lead quickly to a significant decline in foreign reserves (NFA)
2. Governments but with a Flexible Exchange Rate can use monetary financing of deficits but the inflation costs will be high especially where (i) the normal level of money holdings relative to GDP is low and (ii) where the public reduce money holdings rapidly in response to rising inflation (e.g. Zimbabwe today)
3. In practice these two cases may not be that much different in practice since **unofficial** (black market) exchange rate movements will quickly follow in response to high inflation (e.g..Zaire and Zimbabwe)
4. Both domestic borrowing and external borrowing can mitigate the problems BUT (i) voluntary domestic borrowing for governments is frequently very low and (ii) both domestic and external borrowing involve interest costs that may rapidly increase the overall fiscal deficit – which itself has to be financed.
5. “Messy “ finance offers an escape route but creates a whole set of problems of its own

SO THERE IS VERY RARELY A FREE LUNCH!

A 4 Minute Question Break

A low-income developing country with basically sound policies and a strong commitment to poverty reduction faces an increased BoP deficit because of a sudden fall in its export earnings for its main exports namely coffee and tea. The country can borrow more to finance this extra deficit but knows that it is already close to its sustainable debt limits.

So it is considering (i) an ER devaluation to try to expand exports and/or (ii) a tighter monetary and fiscal policy to deflate its import volumes.

List some of the possible effects on its poverty-reduction agenda AND on its levels of indebtedness that may follow from policies (i) and (ii).

SESSION TWO

Applying what we have learned about Macro constraints to examine some dilemmas for the social (including children) agenda in present day Uganda

Topic 5: Bringing it Together

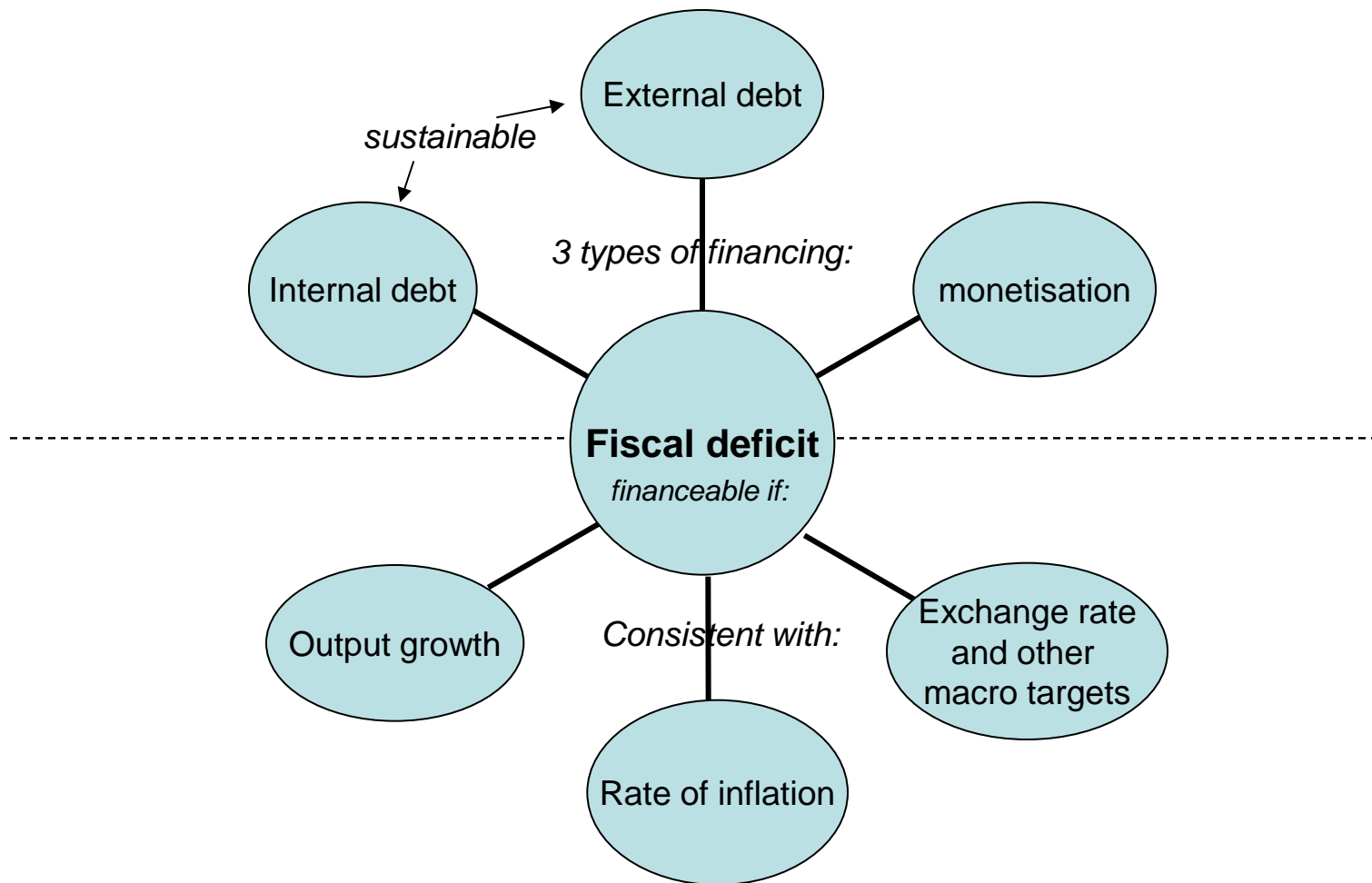
This last topic may help us to understand why Ministers of Finance often seem to be so insensitive to the needs of the social budget and to the underlying problems of poor families etc.

AND

Why the balancing of all the Macroeconomic constraints is a hugely difficult task in almost all low income countries.

We use the example of a relatively well run African country namely Uganda to show that even in such cases, the problems are ever to the fore.

The Minister's Dilemma in Summary



An Integrated PRSP Framework

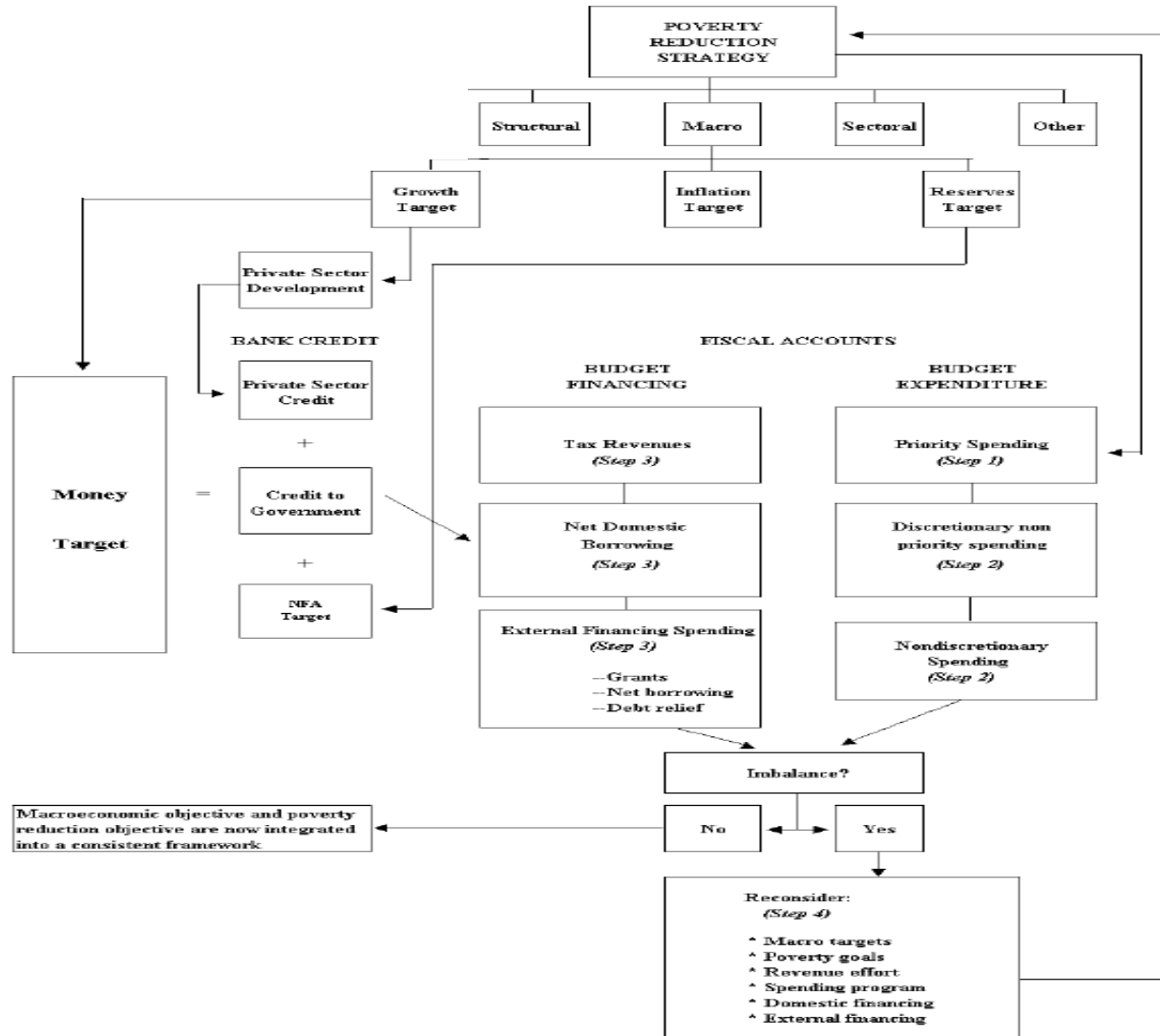
The Figure that follows shows a fully framework taken from the World Bank's PRSP Source Book.

Please be aware of this

We will review a few main features of this in the remaining slides.

PLEASE PRINT THE NEXT SLIDE AS A FULL PAGE

Figure 1: Financing Poverty Reduction Strategies in a Sustainable Manner



The Parameters defined by IMF Agreements (in the present programme)

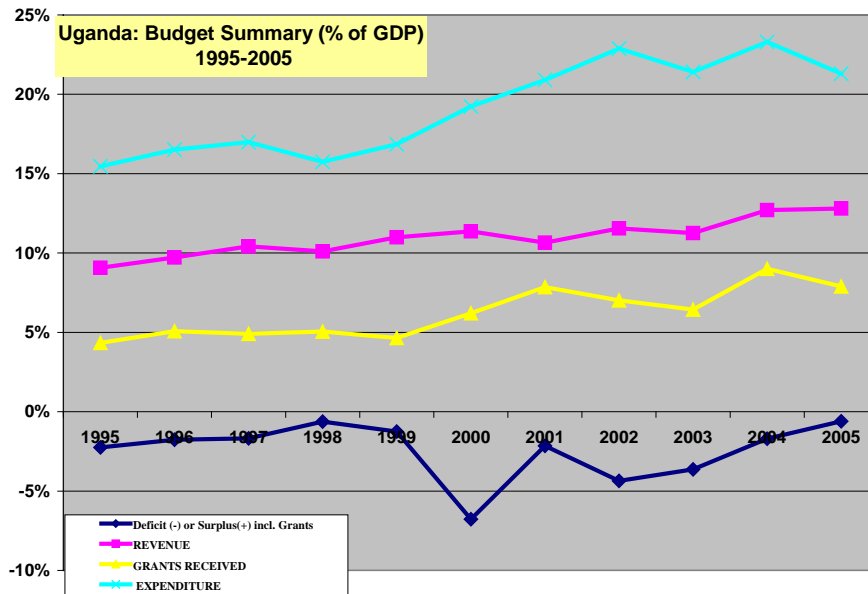
The Minister also needs to formally observe the following NUMERICAL limits under Uganda's present *Policy Support Instrument* Programme (PSI) with the IMF.

- Ceiling on base money liabilities of the Central Bank (BOU)
- Ceiling on outstanding bank credit to the GOU
- Ceiling on the stock of external payments arrears of the GOU and BOU
- Ceiling on new non-concessional longer-term external borrowing by the GOU and central bank
- Ceiling on new external short-term debt of GOU and BoU
- Minimum target increase in international reserves (NFA)
- Target to reduce domestic budgetary arrears
- Ceiling on public administration expenditures

The Macroeconomic Framework

	2004/05	2005/06	2006/07	2007/08
	Act.	Act.	Proj.	Proj.
GDP and prices (percent change)				
Real GDP	6.7	5.4	6.2	6.5
Headline inflation (average)	8	6.6	7.5	5.1
Underlying inflation (average)	4.7	5.2	8.1	4.5
External sector (percent change)				
Terms of trade (deterioration –)	1.9	16.5	11.7	-8.8
Real effective exchange rate (depreciation)	11.2	-1.3
Savings and investment (percent of GDP)				
Domestic investment	21.1	23.1	24.2	26.3
Public	4.5	4.4	5.1	5.6
Private	16.6	18.7	19.2	20.7
National savings (excluding grants)	10.6	13.2	15.7	14.8
Public	-3.9	-3	-3.4	-2.2
Private	14.5	16.2	19.1	17.1
External sector (percent of GDP)				
Current account balance (including grants)	-2.1	-4.1	-2.5	-7
Net donor inflows	8.9	8.4	8.6	8
Current account balance (excluding grants)	-10.6	-9.9	-8.6	-11.4
External debt (including Fund)	50.7	43	13.6	16.7
External debt-service ratio 3 4	9.8	5.8	3.3	3.9
Government budget and debt (percent of GDP)				
Revenue 5	12.8	13.2	13.1	13.6
Grants	7.9	6.6	5.9	4.4
Total expenditure	-21.3	-20.6	-21.5	-21.5
Overall balance (including grants)	-0.6	-0.8	-2.5	-3.5
Overall balance (excluding grants)	-8.5	-7.4	-8.4	-7.9
Stock of domestic debt	9.8	9.1	7.2	6.3
Money and credit (percent change)				
Broad money (M2)	12.1	18.9	15.3	17
Domestic credit	-4.8	7.2	3.3	11.6
Credit to the central government 2	-10	-4.8	-7.2	0.6
Private sector credit	13.9	28.3	22.2	24.1

An Example: Uganda



Selected Expenditures (% of GDP)

	2001	2002	2003
Interest Payments (Sh billion)	116	146	174
<i>ratio to GDP</i>	1.1%	1.3%	1.4%
Health (Sh billion)	315	391	399
<i>ratio to GDP</i>	3.1%	3.6%	3.1%
Education (Sh billion)	437	544	561
<i>ratio to GDP</i>	4.3%	5.0%	4.4%
Social Protection (Sh billion)	39	19	20
<i>ratio to GDP</i>	0.4%	0.2%	0.2%
Total Health, Education, Social (Sh bi	791	954	981
<i>ratio to GDP</i>	7.8%	8.8%	7.7%

Issues for the Minister

1. Budget Fragility

- Total Budget Revenues (excluding grants) are only 12% of GDP - only slightly more than TOTAL Social Expenditures and the Interest Payments
- These revenues also fluctuate by up to 3% of GDP from year to year – a fluctuation equivalent to almost the whole of the Health budget
- Grants are now equal to some 8% of GDP but these too can fluctuate (i) from year-to-year and (ii) from budget numbers to actual outcomes, by up to 2%: equivalent to the whole Social Protection Budget plus the bill for interest payments

2. Inflation Financing

- Uganda's recent macroeconomic stability– inflation consistently below 10% since 1995 owes much to a low maintained inflation target (now 5% or less)
- But since the monetisation ratio in Uganda is only around 18%, the Minister is restricted to well under 1% of GDP of financing from the inflation tax ($5\% \times .18 = 0.9\%$)
- He could relax his inflation target but would then expect to face significantly higher interest rates on government debt – see next slide

Issues for the Minister

3. External Debt

- Uganda's External Debt is now more sustainable after HIPC relief (including recent Multi-lateral Debt write offs -30% of GDP from 2006/2007) but External Debt O/S still >50% of GDP
- Growth of GDP around 5% allows for some \$400 million a year consistently with a stable debt ratio
- But only IF the interest terms on this borrowing are kept below or close to the expected rate of GDP growth (5-6%). If growth falls short of this target, then far lower new net borrowing is possible
- Similarly a real devaluation (see next slide) would reduce the Minister's head-room for new borrowing.

4. Domestic/Internal Debt

- Uganda's domestic public debt amounts to over 9% of GDP – and so is relatively modest.
- But with T Bill rates as high as 15% in 2003/2004, the budget cost is still circa 1.4% of GDP
- New Domestic Borrowing is the first recourse for the Minister should there be a failure in some other aspect of his budget. So for example, the one year collapse of grant funding could easily double these ratios and absorb up to half of all Health sector funding

Issues for the Minister

5. The Real Exchange Rate

- Uganda has a large external current deficit (10% of GDP excl. grants and 4% of GDP incl. grants) in spite of broadly favourable commodity prices
- The real Exchange Rate has appreciated by some 15% since 2000
- Although this further eases the pressure on (i) prices and (ii) the real burden of debt, it also puts cumulative pressure on Uganda's export sectors
- A significant real devaluation to restore the 2000 parity would increase the debt burden by more than Sh. 1,500 billion and so remove some 4 years of the sustainable new borrowing noted on the previous slide.

6. Arrears

- The Minister also has to deal with some Sh. 610 billion of unpaid arrears of domestic wages, pensions and other domestic budget commitments.
- These arrears represent the unbudgeted financing of past years.
- Paying them off *in full* would eat up almost 25% of a year's budget expenditures and 43% of a year's domestic budget revenues. This would be equivalent to ALL social expenditures for one year.
- The Minister instead has committed to paying off some Sh. 149-300 billion per annum. This is still a huge dent in his available funds.

Generic Issues (1) -Does Foreign Aid Help?

Any significant scaling up of aid implies significant inflows of foreign exchange to the country

- If this is used FULLY to purchase imports, there is no problem—the foreign exchange comes in and goes out directly for imports
- But if it is used to purchase non-tradeable goods and services (e.g. pay teachers' or nurses' salaries or buy buildings or electricity or transport services), the aid will increase demand for goods and services which *cannot* be supplied from imports
- If the country is able to expand local production and the extra demand is matched by increases in supply—with no effect on non-tradeable good prices, there is no problem and no obvious impact on local inflation

.....if aid **cannot** be used to remove supply bottlenecks

THEN we would see pressures on non-tradeable goods and services prices

- the price of non-tradeables (teachers, buildings etc) will also rise *relative* to the price of tradeable goods: this is an appreciation of the real exchange rate and could divert resources away from exports

Another way to see it: significant increase in aid leads to an increase in R and thus the money supply or “M” (Remember: $\Delta M = \Delta R + \Delta DC$)

BUT

- this change is reversed automatically when aid is used *fully* to buy imports
- otherwise government can choose to sterilise aid inflows (effect on M) by selling Government securities to the local public. But this can raise interest rates on public debt (significantly if the market is small) and probably crowd out private credit (and so negatively affect growth)
- an alternative is NOT to spend the aid – but then why have it?

Generic Issues (2) – Criticisms

of IMF Programs *(Main Source: CDG*

Working Group Report on the IMF and Health Spending, June 2007)

Evidence on outcomes:

- Program and non-Program countries (1998-2005) have seen similar slightly upward trends in health expenditures (\$10 to \$15 per head since 1998)
- But because many SS African program countries have received HIPC support, the increases might have been expected to be higher
- When choices have been available, the IMF has often opted for (i) more debt reduction and (ii) more increase in reserves rather than (iii) more spending
- But there is evidence that IMF programs have shown flexibility to changing circumstances (at least mid-program) – the “one size fits all criticism” is over-simplistic.

IMF Programme Responses to Aid

- Asymmetric responses – forecasts of higher than expected aid flows are *unlikely* to lead to IMF increasing spending targets but forecasts of possible lower aid are *likely* to lead to reduced spending targets: i.e. IMF prone to an “assume the worse” approach
- Insufficient management guidance to IMF staff about how to factor in the different stakeholders (e.g. those advocating more spend on health and education) and the new possibilities that flow from the scaling up of aid – “conservatism” is the default option.
- Weak capacity in both the IMF and in recipient sector Ministries about how to prioritise the possible use of “ a little more funding” and frequently very weak local capacity to take proper account of the macroeconomic constraints. So the system can easily be pushed towards *excessive* rather than *affordable* levels of new spend with the IMF receiving the blame for any cuts associated with sound prioritisation decisions.

Selected Recommendations from the CDG Study

1. The IMF should show more willingness to explore and debate a wider range of macro and spending options
2. IMF management should develop clearer public guidance about how IMF staff need to react to alternative aid paths
3. IMF should do more work to develop and publicise timely information about likely future levels of aid flows and condition its programs accordingly
4. IMF should be more willing to allow macro policies to smooth short term expenditure smoothing at least in those cases where major macro instability no longer threatens
5. Tools need to be developed to allow better interaction and with a broader group of stakeholders over the key expenditure decisions –with parallel improvements also in local institutions

Should UNICEF “buy” into this strategy? – Flashback to Gaspar’s Comments

His answer is - YES BUT NOT UNCONDITIONALLY

NOTE his comments but also the **questions marked in red**

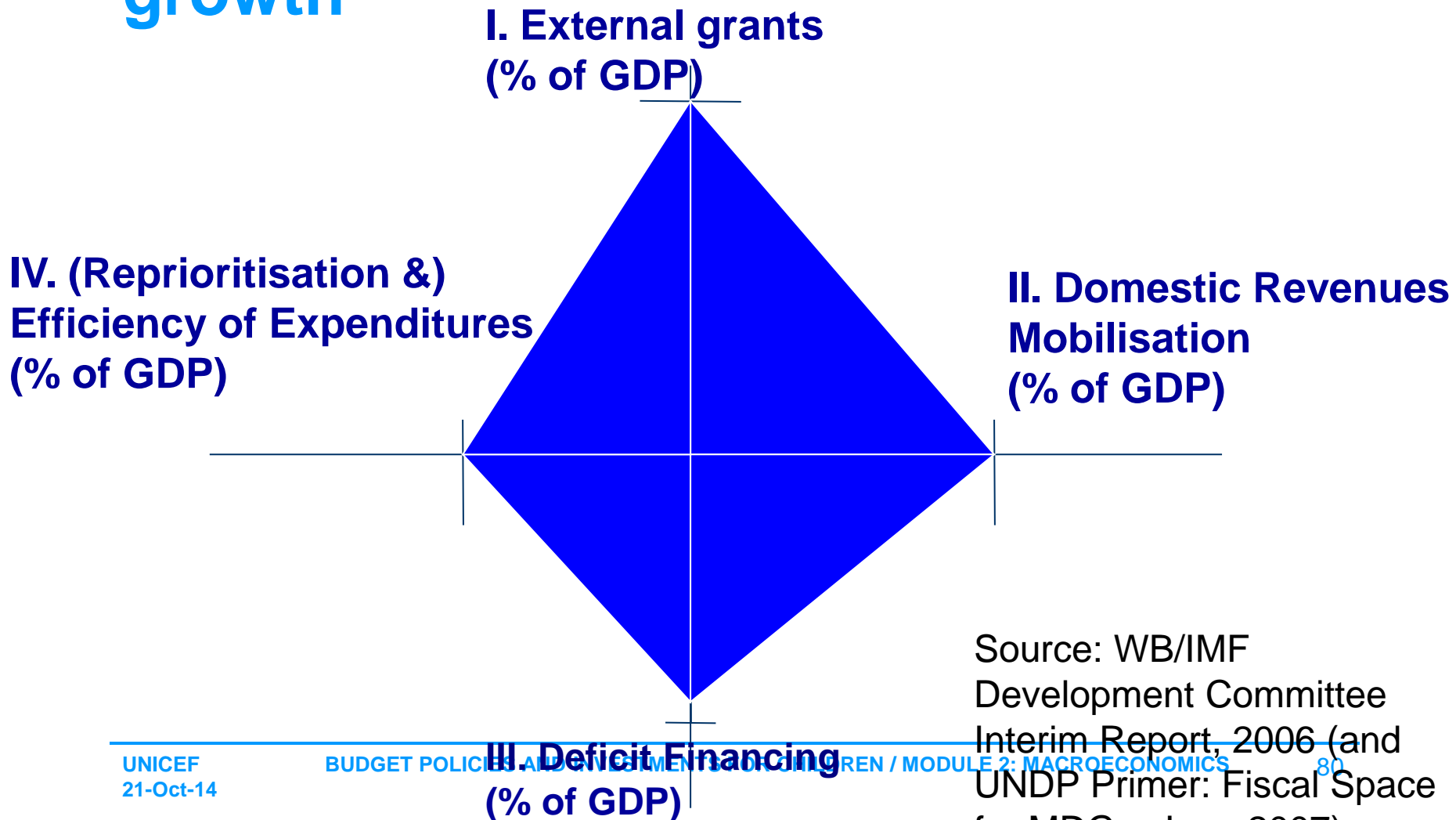
1. While some studies find that while $<5\%$ inflation is good for the size/depth of the financial sector, other find that $< 15-30\%$ inflation can still be good enough with limited harm on growth. **WHAT WOULD BE ANY FURTHER NEGATIVE CONSEQUENCES IN YOUR COUNTRIES OF 30% INFLATION?**

The notion of public spending crowding out private investment is not automatic: it depends on monetary conditions, and may not necessarily be bad. **ARE BANKS SUFFICIENTLY LIQUID AND MOTIVATED IN YOUR COUNTRIES TO CONTINUE TO LEND TO THE PRIVATE SECTOR IN THE FACE OF A SIGNIFICANTLY LARGER DEMANDS ON CREDIT FROM THE GOVERNMENT?**

Taxes or revenues should be strengthened: market liberalization can undermine this by eliminating tariff revenues. Reaching MDGs with taxes 10-15% of the GDP or less will be hard! **WHAT OTHER MACRO REFORMS COULD BE IMPLEMENTED TO OFFSET THE CONCERNS ABOUT LIBERALISATION EXPRESSED HERE?**

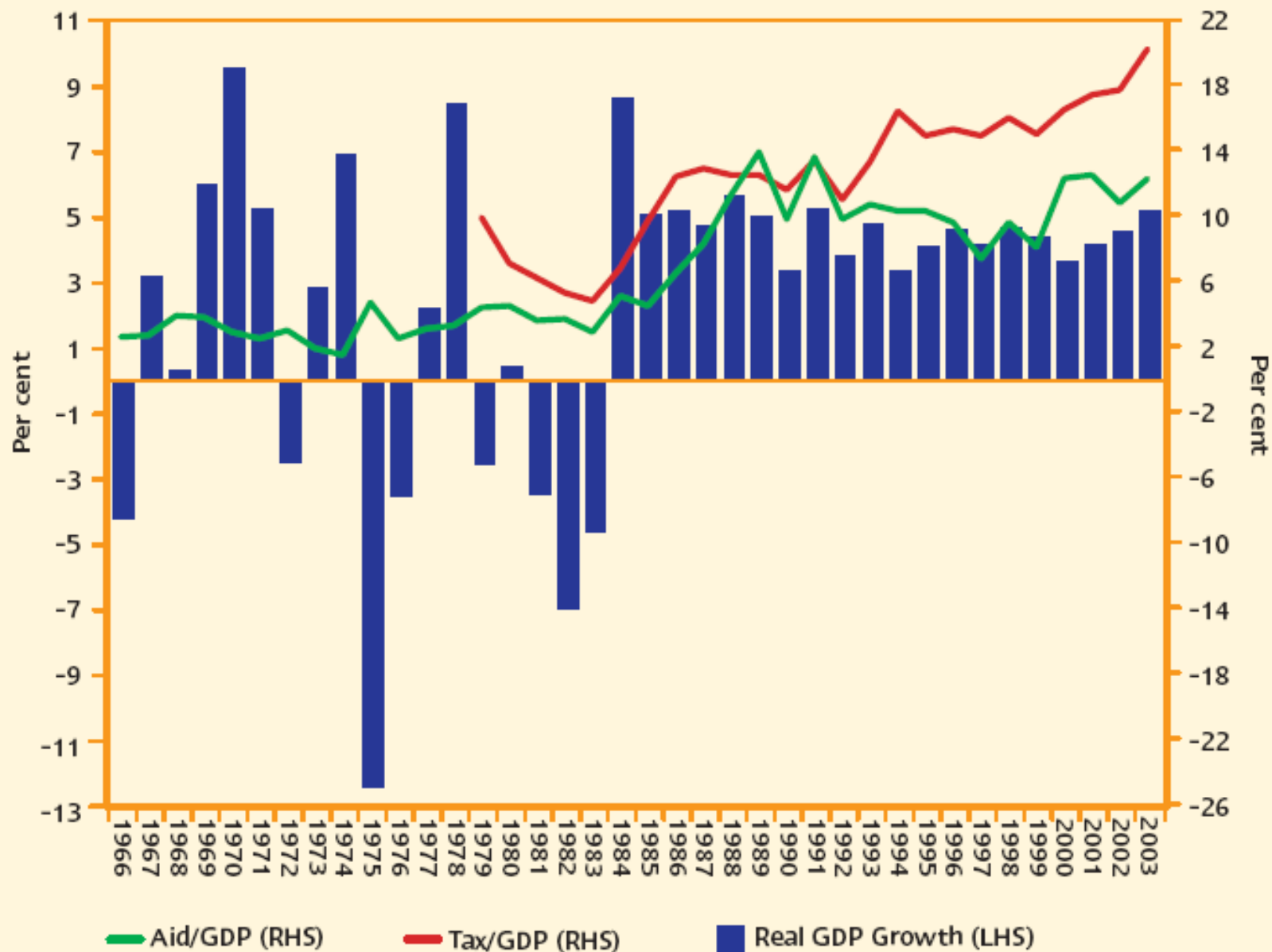
Flexible exchange rate systems might strengthen the need for social protection, livelihood supports **WHAT WOULD A RIGID EXCHANGE RATE SYSTEM DO TO LIVELIHOODS IN THE FACE OF THE HIGHER (30%) INFLATION IN POINT 1?**

Fiscal space diamond – but the freer lunch is easier IF you have growth



Source: WB/IMF
Development Committee
Interim Report, 2006 (and
UNDP Primer: Fiscal Space
for MDGs, June 2007)

Figure A9.1.1 Aid, Revenue and Growth in Ghana



Summary

Uganda has many things going for it now:

- reasonably stable prices and low inflation rates
- a generous HIPC settlement already largely implemented
- a prospect for sustained GDP growth at 5-7%

But even so all the constraints involved in the “Minister’s Dilemma” are still significant:

- The scope for inflation financing has largely been removed by the inflation target
- The head room for new external borrowing created by HIPC relief is highly constrained by the growth rate and by the likely need to devalue the exchange rate
- New domestic borrowing is seriously constrained by accumulated arrears from the past and by interest rate concerns
- External grant and other financing is large but unstable in amount from year to year (and also involves the problems of real exchange rate appreciation and/or interest rate hikes if the Minister chooses to sterilise the aid inflows)

Last Words

It is extraordinarily easy for low-income countries to defend social expenditures in the short term by adopting a variety of rash macroeconomic policies:

- high rates of inflation
- excessive external borrowing at relative high interest cost
- excessive voluntary internal borrowing at high interest rates
- substantial *involuntary* internal borrowing based on raids on banks, pension funds, civil servants pay etc
- various other controls designed to direct more resources to the budget

BUT all these short term devices fail the economy and especially poor people eventually (and often quite quickly), via

- the draconian monetary and fiscal policies that become necessary to eliminate high inflation and excessive debts.
- the tight budgets this year needed to pay back the non-payments of previous years
- the output losses caused by controls that impede efficient productive activity

EVENTUALLY the macroeconomic constraints and realities MUST hold – even low-income countries protect their poor best by recognising this on an ongoing basis.

BUT there is scope to be a bit more flexible than official (and IMF) macro policies have been in the past PROVIDED THAT THE CONSTRAINTS ARE PROPERLY RECOGNISED AND FACTORED IN MORE THAN NOW TO SECTORAL ADVOCACY OF INCREASED SPENDING.