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Macroeconomic Stability and Economic Growth

Broadly speaking, two considerations underlie macroeconomic policy recommendations. First, there needs to be an *assessment of the appropriate policy stance* to adopt in a given set of circumstances (i.e., should fiscal and/or monetary policy be tightened or loosened?). Second, there is the *choice of specific macroeconomic policy instruments* that would be beneficial for a country to adopt (e.g., the use of a nominal anchor, a value-added tax (VAT), etc.). In practice, these two considerations are closely linked. Adjusting a policy stance is often done via the adoption of a new instrument (or the modification of an existing one). More important, both considerations are essential to efforts to enhance an economy's stability.

The specific stance must fit each country's particular situation. These situations can be put into three broad classes: (1) instability/disequilibrium; (2) stabilization (e.g., transition from instability to stability); and (3) stability/steady economic growth. This Section briefly discusses how macroeconomic policies can contribute to stability. For countries that enjoy stable macroeconomic conditions, there is somewhat greater flexibility in the choice of appropriate stance for macroeconomic policy. The central issue for these countries will be to ensure that the financing of their poverty reduction strategies does not jeopardize macroeconomic stability, which will be discussed in the last section of this pamphlet.

Sources of Instability

There are two main sources of economic instability, namely exogenous shocks and inappropriate policies. *Exogenous shocks* (e.g., terms of trade shocks, natural disasters, reversals in capital flows, etc.) can throw an economy into disequilibrium and require compensatory action. For example, many low income countries have a narrow export base, often centered on one or two key commodities. Shocks to the world price of these commodities can therefore have a strong impact on the country's income. Even diversified economies, however, are routinely hit by exogenous shocks, although, reflecting their greater diversification, shocks usually need to be particularly large or long-lasting to destabilize such an economy. Alternatively, a disequilibrium can be "self-induced" by poor macroeconomic management. For example, an excessively loose fiscal stance can increase aggregate demand for goods and services, which places pressure on the country's external balance of payments as well as on the domestic price level. At times, economic crises are the result of both external shocks and poor management.

Stabilization

In most cases, addressing instability (i.e., stabilization) will require policy *adjustment*; whereby a government introduces new measures (possibly combined with new policy targets) in response to the change in circumstances.[16] Adjustment

[16] In certain cases, the return to a steady growth state may also require structural reform and measures to improve the functioning of markets.

will typically be necessary if the source of instability is a permanent (i.e., systemic) external shock or the result of earlier, inappropriate macroeconomic policies. However, if the source of instability can be clearly identified as a temporary shock (e.g., a one-time event) then it may be appropriate for a country to accommodate it.[17] Identifying whether a particular shock is temporary or is likely to persist is easier said than done. Since there is often a considerable degree of uncertainty surrounding such a judgment, it is usually wise to err somewhat on the side of caution by assuming that the shock will largely persist and by basing the corresponding policy response on the appropriate adjustment.

In most circumstances where adjustment is necessary, both monetary (or exchange rate) and fiscal instruments will have to be used. In particular, successful adjustment to a permanent unfavorable shock that worsens the balance of payments will often require a sustained tightening of the fiscal stance, as this is the most immediate and effective way to increase domestic savings and to reduce domestic demand—two objectives typically at the center of stabilization programs.

Adjustment policies may contribute to a temporary contraction of economic activity, but this contingency should not be used to argue against implementing adjustment policies altogether, as the alternative may be worse. Attempting to sustain aggregate demand through unsustainable policies will almost certainly aggravate the long-run cost of a shock, and could even fail in the short run to the extent that it un-

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[17] Broadly speaking, this means leaving the underlying stance of macroeconomic policy unchanged (or, in some cases, the stance may be adjusted temporarily to mitigate the impact of the shock) and adjusting policy targets in a way that takes into account the impact of the shock. However, if such a policy stance cannot be financed in a noninflationary way, then some adjustment will also be necessary.

dermines confidence. In the long run, greater benefits to the poor are to be had as a result of the restoration of macroeconomic stability. The appropriate policies to protect the poor during adjustment are to maintain, or even increase, social expenditures and to adopt, where feasible, compensatory measures that would insulate or offset temporary adverse impacts to the fullest extent possible.[18] This is best done by devoting resources to the establishment of effective social safety nets,[19] as an enduring part of a country's poverty reduction strategy, rather than as a response to crisis. Countries that lack such resources/safety nets could be forced to either subject their poor to the short-term adverse effects of stabilization or to delay the pace with which macroeconomic adjustment proceeds (and put off the corresponding long-term benefits to economic growth and poverty reduction).

Countries in macroeconomic crisis typically have little choice but to stabilize quickly, but for countries in the "gray" area of partial stability, finding the right pace may prove difficult. In some cases, a lack of financing will drive the pace of stabilization. Where financing is not a constraint, however, policymakers will need to assess and carefully weigh various factors on a case-by-case basis in choosing the most appropriate pace of stabilization.

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[18] Indeed, a key feature of programs supported by the IMF's Poverty Reduction and Growth Facility (PRGF) is to assess the distributional impact of key macroeconomic policies and to put in place countervailing measures needed to protect the poor. See *Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs*, August 16, 2000 at http://www.imf.org/external/np/prgf/2000/eng/key.htm.

[19] Social safety nets are designed to mitigate possible adverse effects of reform measures on the poor. These instruments include temporary arrangements, as well as existing social protection measures reformed and adapted for this purpose, such as limited food subsidies, social security arrangements for dealing with various life cycle and other contingencies, and targeted public works. See Chu and Gupta (1998).

Elements of Macroeconomic Stability

Macroeconomic policies influence and contribute to the attainment of rapid, sustainable economic growth aimed at poverty reduction in a variety of ways. By pursuing sound economic policies, policymakers send clear signals to the private sector. The extent to which policymakers are able to establish *a track record of policy implementation* will influence private sector confidence, which will, in turn, impact upon investment, economic growth, and poverty outcomes.

Prudent macroeconomic policies can result in *low and stable inflation*. Inflation hurts the poor by lowering growth and by redistributing real incomes and wealth to the detriment of those in society least able to defend their economic interests. High inflation can also introduce high volatility in relative prices and make investment a risky decision. Unless inflation starts at very high levels, rapid disinflation can also have short-run output costs, which need to be weighed against the costs of continuing inflation.

By moving toward *debt sustainability,* policymakers will help create the conditions for steady and continuous progress on growth and poverty reduction by removing uncertainty as to whether a government will be able to service new debt. By keeping domestic and external debt at levels that can be serviced in a sustainable manner without unduly squeezing nondebt expenditure, policymakers can also ensure that adequate domestic resources are available to finance essential social programs.

Inappropriate *exchange rate policies* distort the composition of growth by influencing the price of tradable versus nontradable goods. Household survey data for a number of countries indicate that the poor tend to consume higher amounts of nontradable goods while generating relatively more of their income from tradable goods (Sahn, Dorosh, and Younger, 1997). Hence, in addition to distorting trade and inhibiting growth, an overly appreciated exchange rate can impair the relative incomes and purchasing power of the poor.

By building and maintaining *an adequate level of net international reserves,* a country can weather a temporary shock without having to reduce essential pro-poor spending. External shocks can be particularly detrimental to the poor because they can lower real wages, increase unemployment, reduce nonlabor income, and limit private and net government transfers. The level of "adequate" reserves depends on the choice of exchange rate regime.