Chapter 2

Meeting the Macroeconomic Challenges

A. Responses to the current global economic crisis

As discussed in the introduction to this Report, least developed countries (LDCs) are going to be severely affected by the current global financial crisis and global recession. The main channel of impact is not likely to be through the financial system, as LDCs' financial sectors are weak and not tightly integrated with those of advanced countries, and they receive only modest inflows of private financial capital. However, LDCs are bound to be adversely — though differentially — affected by the slowdown in the real global economy, particularly through falling export revenues and declining workers' remittances, as well as falling inflows of net private capital, particularly foreign direct investment (FDI).

LDCs are bound to be adversely affected by the slowdown in the real global economy, particularly through falling export revenues, workers' remittances and FDI.

How should the macroeconomic policies of LDCs be modified in light of the global deterioration in real and financial conditions? What should be the role, for example, of counter-cyclical fiscal and monetary policies? And can LDCs continue some of the growth momentum that they achieved prior to late 2008, based on maintaining the financing of public investment and the stimulus of private investment?

It will be important for LDC Governments to continue to devote a significant share of their budgets to public investment, which will enable them to maintain some degree of momentum in their previously achieved growth trajectories, which were brought about by the global boom in the export of primary commodities. It would be a mistake for LDCs to reduce taxes in order to provide a fiscal stimulus to their economies. Their taxes are already low. Reducing them further would undermine their long-term basis for domestic resource mobilization. Also, such reductions would be unlikely to provide much short-term stimulus, because part of the tax relief would be saved instead of spent. This is why public expenditures tend to have a larger multiplier impact on an economy than tax reductions.

The central challenge for LDCs will be to balance the need for short-term counter-cyclical measures with the longer-term priority of financing public investment as the basis for expanding their productive capacities.

Despite the economic slowdown, Governments should continue to invest in building up their capacities to raise domestic revenues. While tax revenues will surely decline in the coming period, as incomes drop, there is no reason why the capacities to raise more revenue in the future cannot be strengthened in the near term.

The central challenge for LDCs will be to balance the need for short-term counter-cyclical measures — to provide a needed stimulus to their economies — with the longer-term priority of financing public investment as the basis for expanding their productive capacities. The debate on the relative weights of current expenditures and capital expenditures is reflected in the proposed composition of the annual budgets of many of the industrialized countries. While recognizing the need for a short-term stimulus, these countries are also insisting on devoting a significant share of their budget resources to long-term investment projects, such as projects for improved healthcare and education, expanded infrastructure, and greater self-sufficiency in energy.

Needless to say, the industrialized countries, and the United States in particular, have the option of borrowing (selling government securities) in order to finance their fiscal deficits. Unfortunately, LDCs cannot market their securities internationally without incurring high costs for debt servicing, and they have shallow domestic bond markets. In order to borrow domestically, they are charged extremely high real rates of interest. Hence, one of the frequent sources of finance for the fiscal deficits of LDCs is official development assistance (ODA).

Donor countries should stick to their previous commitments to ODA and increase financing to offset the negative impact of the global recession on LDCs.

One problem in this regard is that ODA may decline as the industrialized countries grapple with their own domestic financial crises and recessions. It is imperative that donor countries stick to their previous commitments to ODA and also increase donor financing to offset the negative impact of the global recession on LDCs. Continuing to provide debt relief, where it is necessary, would also make a great deal of sense, particularly because this is unlikely to have a large short-term impact on donor-country budgets. In some cases, a debt moratorium should be considered. Complementary measures, such as reducing significant subsidies to domestic agriculture in donor countries, would be a win-win solution — reducing the expenditures of rich countries while also brightening the export prospects of poor countries.[1]

Reducing significant subsidies to domestic agriculture in donor countries would be a win-win solution.

The case for continued external assistance could be reinforced by devoting greater emphasis to the transparency and predictability of aid, and above all, to improving the capacities of LDCs to raise domestic revenues and mobilize resources for development finance (section B.4 of this chapter). Over the long term, such capacity-building will pay significant dividends by lessening the reliance of LDCs on ODA, and laying a solid foundation for achieving self-sustaining processes of rapid capital accumulation, improved technical progress, and accelerated catch-up growth and development.

Improving the capacities of LDCs to raise domestic revenues will pay significant dividends by lessening the reliance of LDCs on ODA.

B. Fiscal policies

1. Introduction

Among macroeconomic policies, fiscal policies play the central role in helping LDCs to achieve more rapid and sustainable growth and development. They should also play the leading role in providing counter-cyclical stimulus during periods of economic downturn, as LDCs are likely to experience in the current period. But one problem facing national policymakers is that their ability to choose the most suitable fiscal policies for the conditions of their own country is often constrained, as their investment programmes are highly aid-dependent (box 5).

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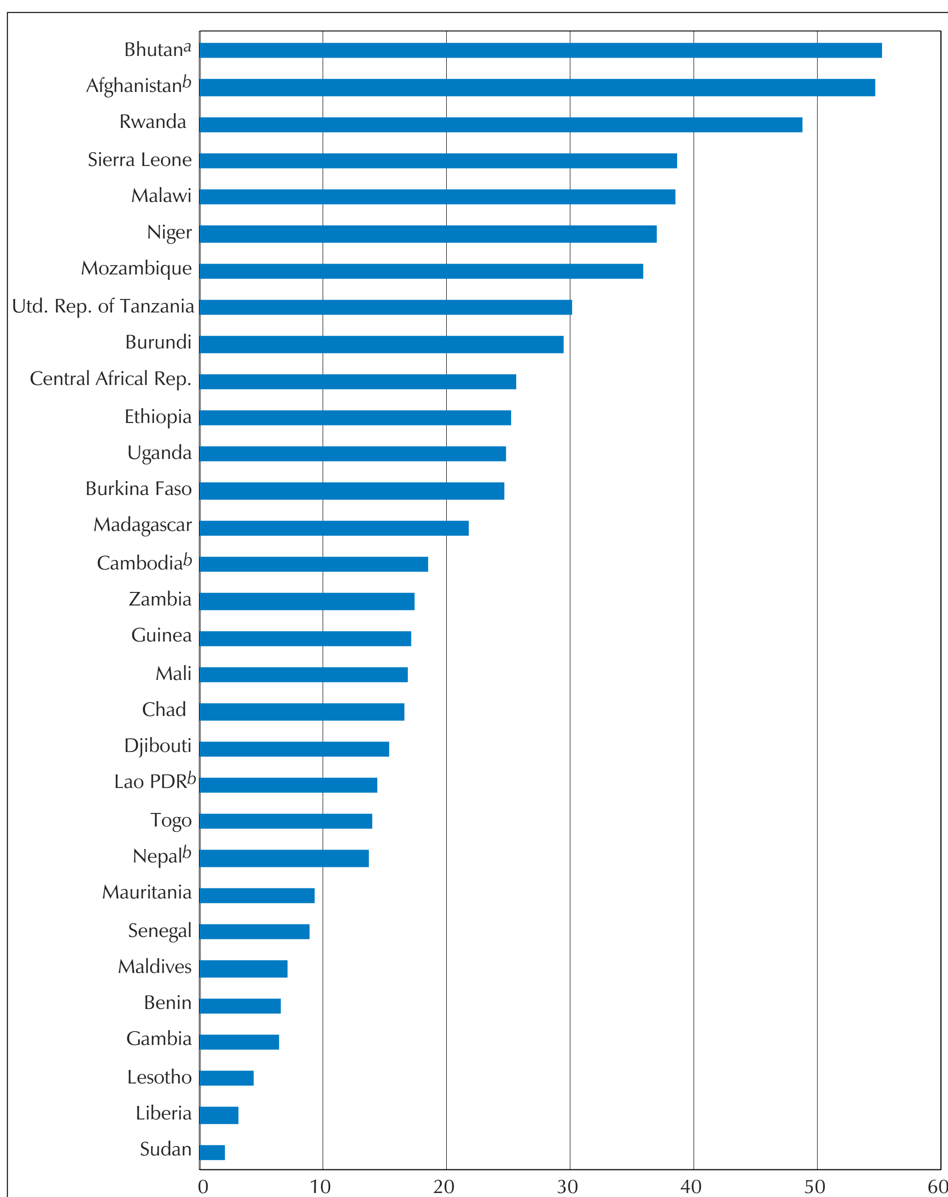
The current macroeconomic consensus focuses on maintaining macroeconomic balance, and in particular on containing the public debt and fiscal deficit. It also favours adopting clear fiscal rules and avoiding the use of discretionary interventions.[2] Fiscal interventionism, it believes, contributes mainly to widening deficits, creating unsustainable levels of debt and exacerbating inflation.

In general, the macroeconomic consensus argues against a leading role for fiscal policy and prefers monetary policy to assume this function. However, except in crises, monetary policy should be bound by "policy rules", such as trying to maintain a low inflation target in order to anchor inflation expectations and create a conducive environment for investment. There is little room left for "discretionary" monetary policies (Weeks and Patel, 2007).

Box 5. The macroeconomic policy space in LDCs

Most LDCs have low levels of domestic resource mobilization, owing to generalized poverty and to the low levels of development of the formal economy as well as of productive capacities. As a result, they are highly aid-dependent. In 11 African LDCs, for example, grants financed between approximately a quarter and a half of total government spending in 2008 (box chart 1).

Box chart 1
Government spending financed by grants in selected LDCs, 2008
(Grants as a share of total Government expenditure, per cent)



Source: UNCTAD secretariat calculations, based on data from OECD-AfDB-UNECA, *African Economic Outlook 2009* (for African LDCs); and on data from IMF, *International Financial Statistics* online and *Government Finance Statistics* online (May 2009) (both for Asian LDCs).

Notes: For African LDCs, grants as a share of total expenditure and net lending.
For Asian LDCs, grants as a share of cash payments for operating activities plus net acquisition of non-financial assets.
a 2004; *b* 2007.

To raise much-needed funding, national Governments must negotiate with donors and creditors, giving both of them influence in formulating policies. National macroeconomic policy space is thus limited by the conditionalities that

Box 5 (contd.)

international financial institutions and bilateral donors attach to the disbursement of resources, and by donors' choices. The nature of these conditionalities has changed over time, and efforts are being made to make them more flexible, as is analysed in *The Least Developed Countries Report 2008* (UNCTAD, 2008a: 93–134). However, conditionalities can still be attached to specific aspects of macroeconomic policies (e.g. quantitative targets for monetary and credit aggregates and inflation, limits to government spending and to the budget deficit, exchange rate adjustment, foreign debt management, and elimination of price controls), to aspects of structural policies (e.g. social security reform, measures to improve financial sector operations, trade liberalization, privatization, and capital flows liberalization), and increasingly, to good governance (e.g. changes in Governments' administrative structures and processes). Typically, these conditionalities steer borrowing countries towards policies in the spirit of the Washington Consensus, and frequently, towards restrictive macroeconomic policies.

In March 2009, the International Monetary Fund (IMF) announced a new approach to its conditionality framework, foreseeing a more flexible use of structural performance criteria and a greater shift towards ex ante conditionality. This revision may change the modalities in which the framework operates, but it is not clear that the types of conditions that LDCs must meet will change.

Apart from multilateral institutions, bilateral donors can also exert strong influence on the policies adopted by LDCs, particularly on the LDCs that are more aid-dependent. Donors can weigh on the content of macroeconomic policies chiefly through decisions on the allocation of their funds, choosing from alternative priorities, areas and programmes. This can happen even when aid is devoted to budget support (UNCTAD, 2008a: 93–134). Since the 1990s, ODA to LDCs has been increasingly allocated to social spending (particularly health and education), rather than to economic infrastructure and production sectors (section B.4 of this chapter; UNCTAD, 2008a: 26–32). However, the poverty reduction strategy papers (PRSPs) are increasingly concerned to develop production and economic infrastructure.

As can be seen from the recent policy changes in advanced countries, in times of crisis, maximum flexibility is required.

Mainstream macroeconomics also warns against large public expenditures partly because it believes that they would serve chiefly to "crowd out" (displace) private expenditures. This would result from increased borrowing by the fiscal authorities in order to finance the resultant deficit. The heightened competition with the private sector for the available pool of finance would drive up the rate of interest.

Orthodoxy has not adequately highlighted the importance of mobilizing domestic resources.

The current macroeconomic consensus also downplays the central importance of public investment, because it believes that such investment competes with private investment and is prone to be more inefficient since it is not driven by market incentives.

On the revenue side of fiscal policy, orthodoxy has not adequately highlighted the importance of mobilizing domestic resources. This might be attributable, in part, to a bias towards maintaining a small State, or to a lack of emphasis on the necessity of creating essential economic and social infrastructure, or simply to poor advice on tax policies. In any case, LDCs have not been able to mobilize sufficient domestic revenue, even during the recent years when both growth and trade were accelerating.

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The issue of revenue generation is addressed in the second part of this section on fiscal policies. First, the role of public expenditures and investment is discussed.

2. Alternative fiscal policies — expenditures and investment

This chapter advances an alternative view on more growth-oriented and inclusive macroeconomic policies. Fiscal policy plays the central role in this approach, driving the development process primarily through public investment, while monetary and financial policies are designed to stimulate private investment, and exchange rate policies are tailored to support export growth.

Because of their structural underdevelopment, LDCs are especially in need of such alternative macroeconomic policies. The advocacy on behalf of strategies based on the Millennium Development Goals (MDGs) has helped to focus greater attention on the need to dramatically increase public investment. Gross fixed capital formation in LDCs did increase during the period from 2000 to 2007 — compared to its level in the 1980s and 1990s — but it remains insufficient to address their needs. During the period from 2000 to 2007, gross fixed capital formation averaged 19.9 per cent of gross domestic product (GDP) for all LDCs (chart 9A). This was an increase from its levels of 17.1 per cent in the 1990s and 16.1 per cent in the 1980s.

Gross fixed capital formation in LDCs increased in 2000–2007, but it remains insufficient to address their needs.

However, gross fixed capital formation has been continuously lowest among the African LDCs. During 2000–2007 it was 18.7 per cent of GDP for this group, whereas for Asian LDCs it was 21.6 per cent (chart 9B). Fixed investment was far higher in island LDCs (27.5 per cent of GDP in 2000–2007), but this is mostly explained by size effects, as these economies are relatively small in terms of GDP.

As global growth has slowed in late 2008 and early 2009, greater efforts must be mounted to mobilize development finance and to maintain progress towards the MDGs. Fiscal policy will also need to be used increasingly, both as a counter-cyclical tool to stabilize LDC economies, and to sustain a medium-term growth trajectory.

Much of the financing of domestic investment was provided by ODA.

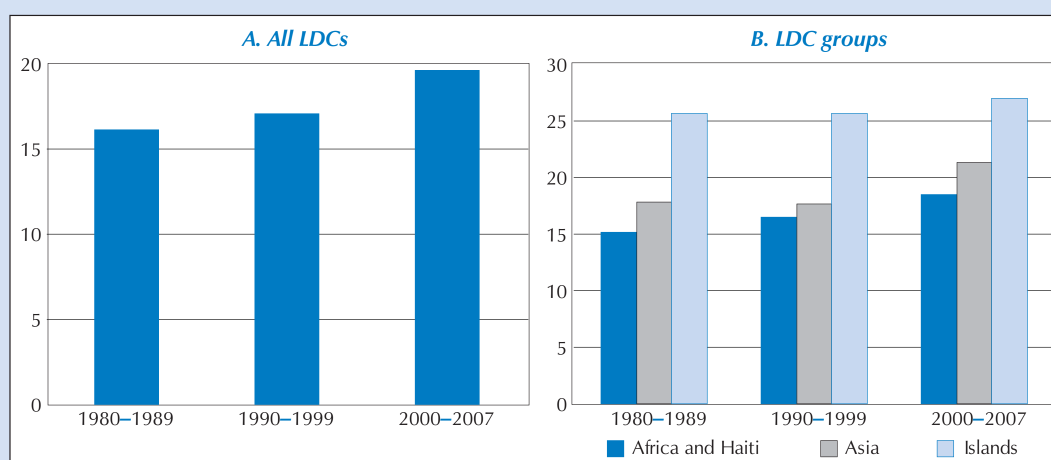
Until late 2008, much of the growth in LDCs was driven by the export of primary commodities — not by internal demand resulting from increased public and private investment. Much of the financing of domestic investment was provided by ODA. Hence, the growth of LDCs was not sustainable, even before the onset of the financial crisis in the industrialized countries and the ensuing global economic slowdown (UNCTAD, 2008a: 1–44).

The growth of LDCs was not sustainable, even before the global economic slowdown.

In the face of a collapse in domestic aggregate demand, policymakers in the industrialized countries have resorted to Keynesian stimulus policies. This has resulted in far more expansionary fiscal and monetary policies, as well as direct measures to stabilize these countries' banking systems. Accordingly, the intellectual

Chart 9

Gross fixed capital formation in the LDCs, 1980–2007
(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on data from the United Nations/DESA Statistics Division.

environment is much more conducive to building a case for longer-term use of expansionary policies. For LDCs in particular, the debate has to move beyond "crisis Keynesianism"; it must introduce, in addition, a more structuralist analysis that emphasizes the developmental role of macroeconomic policies.

LDCs will need financing to continue running fiscal deficits, the bulk of which will have to come from external sources. LDCs have been able to run significant fiscal deficits because a large proportion of their deficits is covered by ODA. This has become, in fact, one of the major purposes of ODA financing — to enhance the ability of Governments in LDCs to expand public expenditures for development-related purposes. Such external financing will now become even more critical, when LDC Governments have to implement counter-cyclical fiscal policies in order to maintain aggregate demand.

For LDCs the debate has to move beyond "crisis keynesianism" to emphasise the developmental role of macroeconomic policies.

It is important to stress that deficits can be justified on two major counts. Firstly, government expenditures can compensate for falls in private spending during economic downturns. This is the standard Keynesian rationale for boosting aggregate demand in order to support economic recovery. Insisting inflexibly on containing fiscal deficits during a recession will make fiscal policy "pro-cyclical". In other words, it will require government spending to fall as private incomes drop, because government revenues will be adversely affected.

More generally, running deficits can be justified, even in normal times, if the resources are used to support public investment. Indeed, the additional future revenues expected from the investment will pay off the debt that the Government incurred. This could be called the "growth rationale" (box 6).

Box 6. The role of public investment

(a) The three functions of public investment

Public investment is of central importance, because it can perform three essentially different functions: (a) expanding the productive capacity of an economy; (b) helping to stimulate aggregate demand; and (c) differentially allocating resources across an economy, whether for the purposes of generating employment, reducing inequalities or combating poverty.

For the purposes of long-term growth and development, the first function is paramount. It is through this function that public investment can help stimulate private investment and raise labour productivity. This is based on building the essential economic and social infrastructure on which private investment depends. Examples are roads, electrical grids, dams, irrigation works, and an educated, skilled and healthy workforce.

Public investment also stimulates aggregate demand, and may well play a counter-cyclical role in this regard. However, current expenditures are more easily adapted to counter-cyclical objectives, since they can be activated in a quicker and timelier fashion. Investment projects usually take longer to initiate and are carried out over a longer time frame.

Some capital projects can be used, however, for counter-cyclical purposes during an economic downturn. Classic examples are what the International Labour Office calls "labour-intensive public works", in which unemployed workers are mobilized to construct small-scale infrastructure and the capital equipment that they use is fairly rudimentary. Since wages are a major component of the project's costs, they can help to stimulate greater current expenditure.

The third function of public investment — differentially allocating resources across the economy — can be used to serve various objectives. In the case of LDCs, it would be important to promote and support industrial policies that are geared to diversifying the economic structure of these countries and to supporting a self-sustaining process of continuous capital accumulation (chapter 4 of this Report).

However, fiscal policies alone will not be adequate to allocate the resources necessary for an effective industrial strategy. Financial policies will have to be enlisted too, in order to influence the allocation of credit for private investment. This point is discussed in section D of this chapter.

If raising employment is the objective, then public investment could be allocated disproportionately to those sectors that are the most employment-intensive or that have the largest employment multipliers. Lastly, public investment could be focused on reducing inequality or poverty, for example by financing infrastructure in poorer urban or rural areas.

(b) Critiques of public investment

As has already been mentioned, one of the standard critiques of public investment has been that it will not have a net beneficial impact on the economy because it "crowds out" private investment. This is highly unlikely, however, in LDCs,

Box 6 (contd.)

because there is a widespread underutilization of resources. As a consequence, there is usually ample "economic space" for increasing all types of expenditure.

The crowding-out argument only becomes relevant under conditions of full employment, but the logic would then apply to any element of expenditure, whether private or public. In fact, the crowding-out of private investment by public investment would have a net negative effect on economic growth only under very restrictive assumptions. Firstly, the crowding-out would have to be complete — a highly unlikely outcome in countries that have far from full employment. Secondly, public investment would be likely to depress growth prospects only in so far as it is more "capital-using" than private investment (Weeks and Patel, 2007).

Under conditions of less than full employment, it is much more likely that public investment will "crowd in" (stimulate) more private investment, because of the presence of externalities and complementarities between different forms of capital accumulation. This holds true particularly if public investment is concentrated on building basic economic and social infrastructure. A proactive public investment programme should be able, in fact, to stimulate private investment in the sectors of the economy that national policymakers consider to be of strategic importance.

Another standard critique of public investment (particularly in developed countries) is that it tends to be inflationary. This is also not very likely to be the case in LDCs, since public investment should expand the aggregate supply of goods and services, along with stimulating more aggregate demand for them.

There is, in fact, very little plausible evidence to suggest a strong correlation between deficits in LDCs arising from the financing of public investment, and inflation. One of the reasons for the lack of correlation is that inflation in such countries is usually more structural in nature (for example, being due to low domestic productivity) or externally determined (for example, by higher import prices for food or fuels). This topic is discussed further in section C.1 of this chapter.

The effect of deficits on inflation depends, of course, on how they are financed. If they are monetized, then there is a higher probability that they will be inflationary. But this depends on whether the resulting increase in the money supply exceeds the growth of output. So, the overall impact depends on several variables, such as the size of the deficit, the extent of monetization and the rate of economic growth (which affects the demand for money).

Some degree of monetization of fiscal deficits can be justified. Governments in LDCs confront a limited set of options when they run deficits, whether for the purposes of countering recession or of financing public investment. They could sell bonds domestically, but the real rate of interest that most LDC Governments face is relatively high, and the maturity of such securities tends to be short. In comparison, monetization — within strict limits — may be the preferred option. Governments could also borrow internationally, but the interest rate for such borrowing is also likely to be high, since foreign banks will seek to incorporate a sizeable risk premium. The other option is to borrow at concessional rates from regional or multilateral financial institutions or to use the grant component of ODA to finance their deficit. This, in fact, should be a major purpose of ODA — to allow countries to run or expand their fiscal deficit in order to finance development-related expenditures.

3. Alternative fiscal policies — domestic revenue mobilization

There has been much discussion of the problems of "aid dependency" in many LDCs, and while it is clear that reducing it significantly (or entirely) will depend on a take-off into sustainable growth, it is still useful to explore ways of raising domestic revenues as a means of reducing the need for outside help. Revenue generation in LDCs is a significantly correlated with the levels of income per capita and economic growth. A low level of income per capita is a major constraint on raising revenue, primarily because it reflects the underdeveloped economic structure of low-income countries. Such a structure usually contains a large agricultural sector, as well as a substantial informal sector. Formal employment is customarily available only to a small minority of the workforce.

Revenue generation in LDCs is correlated to the levels of income per capita and economic growth.

As economic growth increases, revenue should rise as a ratio to GDP. This has generally been the case in LDCs since the year 2000, however the current global economic slowdown is bound to have already reduced this ratio and is likely to lower it even further in the foreseeable future.

Revenue can be boosted through better tax policies or through more effective tax administration.

But growth alone cannot explain revenue performance. Revenue can be significantly boosted either through better tax policies or through more effective tax administration. In this section, the focus is on tax policies — a topic that has generally been pushed to the sidelines of discussion in development circles in recent years.

Much of the recent discussion has focused on the need to increase ODA in order to promote growth and development in low-income countries, and in LDCs in particular. This has been linked, of course, to the Millennium Development Goals and to MDG-based national development strategies. However, far less attention has been paid to mobilizing domestic revenue, even though this is widely recognized as the primary long-term financing solution.

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It is necessary to examine revenue policy in more depth and to determine how ODA can be used to strengthen the revenue-mobilizing capacity of LDCs. The major problem that many such countries face is that they remain stuck in the short term, with uncertain and unreliable forms of finance.

If these countries are to finance long-term development, they need to mobilize resources on a longer-term basis. This is necessary in order to sustain a process of rapid capital accumulation and catch-up growth and development.

(a) Conventional advice on taxation

Much of the conventional wisdom on taxes has shifted in the last 20 years. Instead of being regarded as a necessity for State-building, taxes are assumed to be a disincentive to private-sector initiative and a net loss to household welfare. The emphasis has been on the loss of private income, but not on the ensuing benefit of revenue-financed public expenditures and investment.

Mobilizing domestic resources on a longer-term basis is necessary in order to sustain a process of rapid capital accumulation and catch-up growth and development.

Concern for an equitable taxation structure has receded, too. Tax theorists now emphasize the negative effects on work and profit-taking from progressive personal and corporate taxes. Therefore, top tax rates on personal income and corporate profits have been falling and the spread of rates has been reduced, from the top downwards.

Trade taxes have also fallen into disrepute, as countries have been urged to become increasingly open to trade and financial flows. Tariff rates have often been radically reduced or eliminated.

Since taxes on trade and corporate profits have been two of the most reliable sources of revenue for Governments in LDCs, their reduction has exerted considerable pressure on Governments to find alternative sources of revenue.

Conventional tax advice has highlighted the need for value-added tax (VAT) as the principal way to offset the losses from trade liberalization and the lowering of direct tax rates. There has also been a presumption among supply-side tax theorists that lowering what they regard as high rates of direct tax will expand the tax base, by encouraging more households or businesses to pay taxes.

As VAT has been introduced across many developing countries, it has generally failed to significantly boost revenue from the levels that had been achieved by previous indirect taxes.

But there is no persuasive evidence of a correlation between lowering rates and expanding the tax base. Moreover, in the context of low-income countries — and LDCs in particular — VAT is not likely to be as efficient as in developed countries, in part because of the need for extensive bookkeeping and the prevalence of a large informal sector.

As VAT has been introduced across many developing countries, it has generally failed to significantly boost revenue from the levels that had been achieved by previous indirect taxes, such as sales taxes. Nor has it compensated, in many cases, for the losses incurred from reducing or eliminating tariffs.

The results of tax reforms for a sample of 22 LDCs in sub-Saharan Africa can be examined on the basis of revenue data collected by IMF for these countries. The

data are derived directly from the statistical appendices of Article IV Staff Reports (and the appendices prepared by IMF for the periodic consultations with each country); they begin from the early 1990s and cover a period of approximately a decade and a half. The data are grouped into three periods in order to identify broad trends: 1990–1994, 1995–1999 and 2000–2006.

Although IMF has supplied data on total revenue for LDCs in sub-Saharan Africa for 2007, as well as estimates for 2008, these are not used here, as it is not possible to separate tax revenue from non-tax revenue, or to disaggregate tax revenue into its major components (IMF, 2008). The data indicate that total revenue was clearly rising through 2008. However, since the analysis here stretches only to 2006, the estimates could be more conservative.

During 1990–1994, average total revenue in African LDCs was 12.3 per cent of GDP...

Even though there appears to have been a discernible upward trend in total revenue around 2005 and 2006 compared with estimates for earlier periods, it is likely that this was a short-lived trend. Moreover, it is also likely that it was heavily influenced by the rise in commodity-related revenue (Gupta and Tareq, 2008). The estimates here appear to be in line with those of the IMF study of Africa by Gupta and Tareq, which investigated the period 2005–2006.

... but by 2000–2006, it increased to 14.8 per cent of GDP.

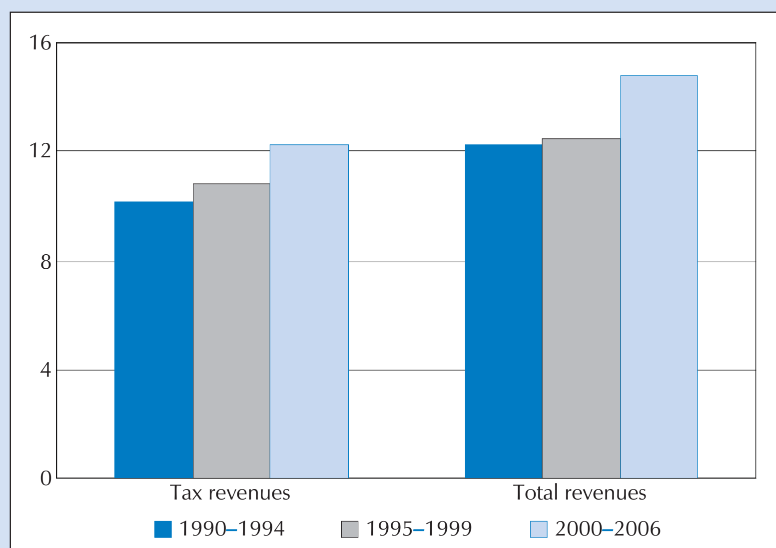
(b) Revenue trends in African LDCs

The analysis begins with an examination of overall trends in total revenue — this includes both tax and non-tax revenue. During 1990–1994, average total revenue was 12.3 per cent of GDP in the African LDCs. By 1995–1999 it had risen very slightly, to 12.5 per cent. But by 2000–2006, it had increased to 14.8 per cent of GDP (chart 10). This represents an overall increase of about 20 per cent (in terms of percentage points of GDP), almost all of it since the year 2000.

Average total tax revenue during 1990–1994 in the African LDCs was 10.1 per cent of GDP; it edged up to 10.8 per cent during 1995–1999, but there was a

Chart 10

Fiscal revenue trends in African LDCs, 1990–2006
(Per cent of GDP)



Source: McKinley (2009), based on data from the IMF.
Note: Based on a sample of 22 LDCs.

bigger increase to 12.2 per cent during 2000–2006. So, overall, there was almost a 21 per cent increase in the share of tax revenue in GDP. Taking the average for just 2004–2006, the level of tax revenue is basically the same, i.e. 12.2 per cent, so there was no evidence of significant progress for LDCs in the later years of our sample.

Indirect domestic taxes in African LDCs increased 65 per cent in their share of GDP between 1990 and 2006 ...

Disaggregating total tax revenue into its three major subcomponents may help to explain the modest increase in tax revenue over the period. Any residual percentages are accounted for by "other taxes". Indirect domestic taxes (i.e. taxes on goods and services) rose significantly in the African LDCs, from 2.9 per cent of GDP during 1990–1994 to 3.7 per cent during 1995–1999, and then to 4.8 per cent during 2000–2006 (chart 11). In other words, there was an overall increase of about 65 per cent in their share of GDP.

Direct taxes (such as taxes on personal income and corporate profits) rose more moderately than indirect domestic taxes. They increased very slightly from 2.7 per cent of GDP during 1990–1994 to 2.8 per cent in 1995–1999, and then rose more significantly to 3.5 per cent during 2000–2006. Overall, their share increased by about 30 per cent.

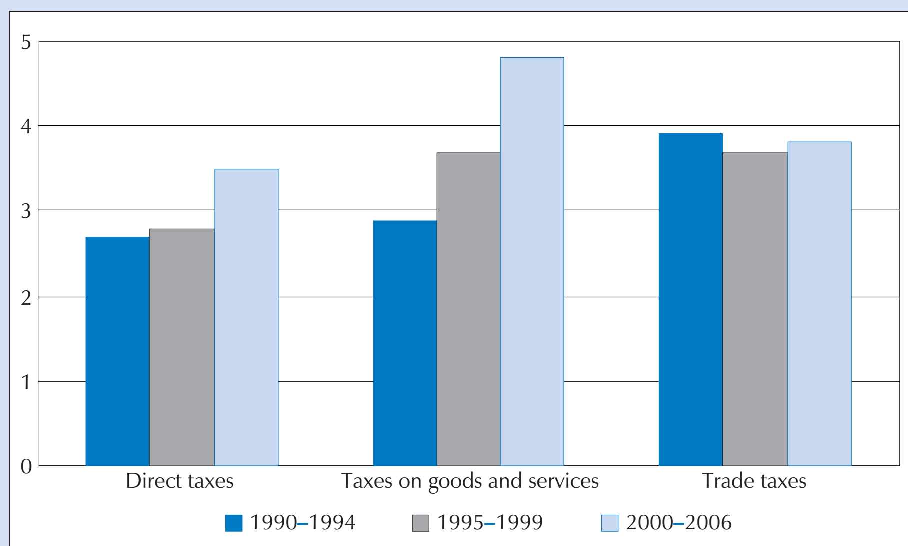
... while direct taxes increased by about 30 per cent.

Trade taxes fell slightly over the whole period. During 1990–1995 they amounted to 3.9 per cent of GDP — higher than either direct taxes or indirect domestic taxes. But by the 1995–1999 period, they had slipped down to 3.7 per cent. Then, during 2000–2006, they edged back up to 3.8 per cent; this occurred mainly between 2004 and 2006.

During 2000–2006, trade taxes accounted for 31.1 per cent of all tax revenue — substantially down from their 38.6 per cent share in the early 1990s. Consequently, trade taxes slipped from first to second place in terms of generating tax revenue. By contrast, indirect domestic taxes rose from 28.7 per cent of total tax revenue in 1990–1994 to 39.3 per cent in 2000–2006, thus surpassing trade

Chart 11

Trends in tax components in African LDCs, 1990–2006
(Per cent of GDP)



Source: McKinley (2009), based on data from the IMF.
Note: Based on a sample of 22 LDCs.

taxes in importance. Direct taxes rose only marginally, from 26.7 per cent to 28.7 per cent of total tax revenue, and remained in third place.

Between 1990–1994 and 1995–1999, direct taxes increased only slightly, and trade taxes declined. Only domestic indirect taxes showed any real improvement, rising from 2.9 per cent to 3.7 per cent of GDP. But comparing 1995–1999 with 2000–2006, improvements are noticeable in the rates of increase both of direct taxes and of indirect domestic taxes, although the pace slowed between 2004 and 2006. Trade rose marginally from 1995–1999 to 2000–2006.

Imports rose significantly between 1995–1999 and 2004–2006...

However, these tax trends have to be placed within the general context of trends in growth and trade. Between 1990–1994 and 1995–1999 there was not a significant increase in trade, as measured by imports and exports. But imports rose significantly between 1995–1999 and 2004–2006. So, the fact that the share of trade taxes in GDP remained the same implies that tariff rates and/or coverage were significantly lowered.

Growth also increased between 1990–1994 and 1995–1999, and more so between 1995–1999 and 2000–2006. Therefore, indirect domestic taxes would be expected to increase as they did, based to a large extent on the corresponding increases in expenditures. But the sluggish increases in direct taxes did not match the faster increases in incomes that took place in the early years of the new millennium. It is likely that the tax reforms involving reductions in the rates of direct taxes, especially on corporate profits, slowed the rise in the share of direct taxes.

... but the fact that the share of trade taxes in GDP remained the same implies that tariff rates and/or coverage were significantly lowered.

These findings cover the period 2000–2006, when both growth and trade were increasing, relative to the trends in the 1990s. So, one would expect less promising findings from the IMF study that only examined tax data from 1990–1991 to 2000–2001 (Keen and Simone, 2004). The IMF study is not directly comparable to the figures given here, because it covered all low-income countries, not just those in sub-Saharan Africa. The value of this study, however, is that it was able to presage some of the trends in tax components that continued until approximately 2005–2006.

In low-income countries in general, the IMF study found that during this period, tax revenue only rose from 14.5 per cent of GDP to 14.9 per cent. The share of direct taxes basically remained stagnant, only edging up from 3.8 per cent of GDP to 3.9 per cent. Indirect domestic taxes rose only modestly, from 5.3 per cent of GDP to 5.9 per cent, and trade taxes fell from 4.3 per cent to 3.7 per cent.

When the IMF study disaggregated the main categories of taxes, it found that corporate taxes had fallen from 2.6 per cent of GDP to 2.0 per cent, which is consistent with the efforts to cut tax rates. At the same time, however, revenue from personal income taxes rose — from 2.8 per cent of GDP to 3.5 per cent. It is also important to note that revenue from property taxes — a source of revenue that is often neglected — declined slightly, from 0.3 per cent of GDP to 0.2 per cent.

The sluggish increases in direct taxes did not match the faster increases in incomes that took place in the early years of the new millennium.

Within the category of indirect domestic taxes, revenue from sales taxes and VAT rose moderately, from 2.8 per cent of GDP to 3.5 per cent. Meanwhile, excise taxes — the other main component of indirect domestic taxes — declined slightly, from 2.1 per cent to 2.0 per cent. Since the rise to prominence of VAT, excise taxes have been relatively neglected as a source of revenue.

The IMF results suggest that the share of total taxes in GDP stagnated during the 1990s. This is consistent with the above results for LDCs in sub-Saharan Africa.

International competition to lower taxes to attract FDI has led to the erosion of corporate tax revenues in many developing countries.

Statutory rates for corporate taxes were dramatically reduced, but the IMF study finds that the tax base did not increase. In fact it decreased, and thus corporate tax revenue fell overall. The study highlights this as an area of concern, since international competition to lower rates (in an attempt to attract FDI) has led to the erosion of corporate tax revenues in many developing countries.

The IMF study concludes that VAT was indeed effective, but that its efficiency gains, in comparison with previous sales taxes, remain to be substantiated, especially in sub-Saharan Africa. An earlier IMF study (Baunsgaard and Keen, 2005) found that in low-income countries, VAT had not compensated for the loss of trade taxes, as had been widely expected. In fact, VAT was found to have recouped only about 30 per cent of the revenue lost in low-income countries by lowering trade taxes.

Countries should refrain from further reducing import tariffs until domestic indirect and direct taxes are able to substantially boost revenue.

So, the Keen and Simone study concludes that in many developing countries, especially low-income countries or LDCs, further trade liberalization is likely to reduce revenue. Consequently, there is a greater need to sequence the reduction of tariffs with the introduction and strengthening of VAT. Now that VAT has been introduced in many countries, the study notes that the chief tasks ahead are to improve its design and strengthen its administration. These tasks, however, are likely to require more time than was originally assumed.

The Keen and Simone study also cautions against the widespread view that tax rates on corporate profits should be lowered further. They have already noted the significant decline in tax revenue from this source, and underlined the weakening of this convenient tax handle.

(c) Implications for tax policies

The above results — taken together with further examination of the experience of individual countries — point towards general outlines for the kinds of tax policies that LDCs both in sub-Saharan Africa and elsewhere could usefully adopt.

Domestic indirect taxes need to be increased at a faster rate than has been the case hitherto.

Firstly, countries should refrain from further reducing tariffs until domestic indirect and direct taxes are able to substantially boost revenue. Recent increases in imports, as has already been mentioned, should have increased revenue from trade taxes. Worryingly, tariffs can be expected to fall further in the coming years, as countries join free trade areas and customs unions and revenues could also fall as the global recession affects trade flows. Since trade taxes still account for a significant share of tax revenue, the revenue losses from further liberalization, especially under conditions of declining trade, could be significant.

Domestic indirect taxes need to be increased at a faster rate than has been the case hitherto. Reducing VAT exemptions could contribute to this goal. Raising VAT rates on luxury consumption items would help to augment revenues and to enhance the equity of the tax structure. Such a change in policy would also help to move some of the tax burden onto higher-income households that can better afford to pay such rates during the global recession.

Particular attention should be paid to strengthening excise taxes, such as those on alcohol, tobacco and vehicles.

Particular attention should be paid to strengthening excise taxes, such as those on alcohol, tobacco and vehicles. Such taxes have been relatively neglected during the introduction of VAT. Targeting excise duties on luxury consumption items would make the most sense. In recent years, countries have reduced excise taxes on food and petroleum, in order to mitigate the impact of rising prices. Keeping such rates at low levels is sensible for the purposes both of poverty reduction and of growth, especially now that growth is slowing in many developing countries.

But this stance would imply instituting — in compensation — greater curbs on the consumption of luxuries or non-essential items.

Increases in revenue from direct taxes have been too modest. High-income taxpayers, who often provide the majority of direct tax revenue, could be covered more effectively. This would improve equity without necessarily raising rates. Setting up special units for high-income taxpayers has produced significant results in a number of countries.

Governments should withdraw from the self-defeating international competition to lower rates on corporate profits.

Reducing tax holidays and exemptions for corporations would contribute to increased revenue. Governments should withdraw from the self-defeating international competition to lower rates on corporate profits. Doing the same for personal income taxes would also make sense.

Statutory rates of corporate income tax fell significantly in sub-Saharan Africa in the 1990s, but the revenue from this source either remained unchanged or fell as a share of GDP. So the supply-side theory that posited a consequent increase in the tax base has not proved to be valid.

Reducing tax holidays and exemptions for corporations would contribute to increased revenue. Doing the same for personal income taxes would also make sense.

Further declines in tax rates on corporate profits should be resisted. In fact, in a significant number of cases in which corporate profits have been based on the extraction of natural resources, such as minerals or oil, a strong case can be made for raising the rates of taxes and royalties.

LDCs should also reconsider the widespread policy of exempting high-income expatriates from paying income taxes. This exemption creates an unfortunate demonstration effect for high-income nationals, encouraging them to believe that it is legitimate for them not to pay taxes (Di John, 2008).

An area of tax policy that has been neglected in LDCs is property taxes, which often finance local Government. Such taxes mainly cover urban areas, where most of the rich and the middle class are concentrated. Strengthening property taxes would help make the general tax structure more progressive. Property taxes can also help to boost domestic production, if they are used to finance the urban infrastructure on which many countries' manufactured export sectors rely.

Strengthening property taxes would help make the general tax structure more progressive.

Some analysts argue that concentrating on property taxes will not produce fruitful results, because of the need to set up a system of property registration. But this argument could just as well work in the opposite direction: stressing the importance of property taxes would lead to greater efforts to set up credible databases of property registration (Di John, 2008). One reason that property taxes are underutilized is that collecting them would require long-term investments in the administrative capacities of the State.

Many analysts point to the severe constraints on mobilizing revenue posed by the structural features of the underdeveloped economies of the LDCs. Widespread informality is one such problem. Many informal-sector enterprises pay negligible tax. Theoretically, VAT should tax the final consumption that such enterprises contributed to, provided that they were part of the value chain that produced the consumption item. But the formal bookkeeping that would be necessary to account for their contribution often fails to capture it.

One way of bringing informal firms into the tax net would be for the State to implement an explicit production strategy that provides them with attractive incentives to register.

Moreover, such firms face a disincentive to becoming part of the formal economy, since they would then become subject to corporate taxes. And yet, they also face the problem of lack of access to formal-sector credit, training, and output markets. So, one way of bringing them into the formal sector, and into the tax net, would be for the State to implement an explicit production strategy

that provides them with attractive incentives. These could include investment in relevant infrastructure, support for marketing and distribution, and microcredit. Based on enhanced access to such benefits, informal-sector enterprises would have greater motivation to register with the tax authorities (Di John, 2008).

The recent upheaval in the financial markets underscores the possibility of taxing the financial sector, especially in order to rein in excessive speculation. Although capital markets are not well developed in LDCs, especially in sub-Saharan Africa, they are developing rapidly in some countries. Imposing a nominal securities transaction tax — for example at 0.1 per cent — could help to raise revenue, and could also stem speculative activities and market volatility. Such a tax could cover — for example — equities, bonds, derivatives and government securities. Various controls on foreign exchange outflows could also help check the volatility of "hot money", which often contributes to destabilizing a country's exchange rate (section E.2(b) of this chapter).

Imposing a nominal securities transaction tax could help to raise revenue, and could also stem speculative activities and market volatility.

4. The role of ODA in domestic resource mobilization

The continuance of sizeable inflows of ODA to LDCs will be critical to their success in maintaining a dynamic rate of long-term growth and development in spite of the deteriorating conditions associated with the global financial crisis and recession.

Unfortunately, ODA earmarked for government and related purposes has neglected critical objectives, such as building national capacities to mobilize domestic savings and raise domestic revenue. Consequently, public and private investments continue to languish in these countries, where substantial investment is most needed.

From the mid-1960s until recently, public investment received little emphasis in development circles. Poverty alleviation programmes did not appreciably improve its status in the 1990s, except perhaps for some investments in social infrastructure.

Increased public investment could "crowd in" private investment, instead of "crowding it out".

The MDG framework, however, has put a sizeable expansion of public investment squarely on the development agenda. There has also been a growing acknowledgement that increased public investment could "crowd in" private investment, instead of "crowding it out". This positive impact is more likely when the capital stock has been allowed to deteriorate over decades, as has been the case in many LDCs (UNCTAD, 2006: 193–220). Under such conditions, initial investments could produce dramatically high returns.

As global conditions deteriorate, it is crucial to try to maintain the development impetus imparted by the MDG agenda, even as fiscal policies have to concentrate more on counter-cyclical interventions.

It is important to try to direct ODA more towards building the domestic capacities of LDCs to mobilize domestic sources of development finance.

In this context, it is important to try to direct ODA more towards building the domestic capacities of LDCs to mobilize domestic sources of development finance. This implies much greater emphasis on mobilizing domestic savings. In turn, such an emphasis implies a greater concentration on reforming and strengthening domestic financial institutions, so that they can more effectively perform the function not only of mobilizing savings but above all, of channelling them into productive investment.

Mobilizing more domestic sources of finance also implies greater attention to mobilizing domestic revenue. In fact, instead of dampening the incentives for mobilizing revenue — as some analysts have claimed — ODA should be channelled into strengthening national capacities to mobilize much more domestic revenue.

Until recently, however, much of the debate on the effectiveness of aid has focused on the danger to macroeconomic stability of the aid upsurge that was projected to accompany the adoption of MDG-oriented national development strategies. Such debate has only served, however, to focus attention on short-term stabilization issues, to the neglect of how ODA could be reformed to contribute effectively to long-term development.

Only a modest 27 per cent of the increase in ODA to low-income Africa during 1999–2005 was programmed to be used to finance fiscal expansion, and growth-enhancing public investment in particular.

The 2007 report entitled *The IMF and Aid to Sub-Saharan Africa,* by the IMF Independent Evaluation Office, is pertinent to the condition of LDCs (IMF-IEO, 2007). The report evaluated the impact of ODA on low-income Poverty Reduction and Growth Facility (PRGF) countries (many of them LDCs) in the period from 1999 to 2005. It found that 36 per cent of ODA to these countries went, at the margin, into reserve accumulation (i.e. was not absorbed) and another 37 per cent was used to retire domestic debt (i.e. was not spent). That left only a modest 27 per cent of the increase in ODA that was programmed to be used to finance fiscal expansion, and growth-enhancing public investment in particular.

For the promotion of long-term growth and development, such an allocation is clearly suboptimal. In the short term, since absorption (100 per cent – 36 per cent = 64 per cent) exceeded government spending (27 per cent), the potential growth of aggregate demand was being constrained. As a result, such a constraint should have tended to dampen any rise in inflation.

Domestic and external financial liberalization has exposed developing countries to recurrent financial crises.

Undoubtedly, domestic and external financial liberalization has exposed developing countries to recurrent financial crises. They therefore needed a credible stock of reserves to counter the effects of potential terms-of-trade or capital-outflow shocks. Those that have amassed a stock of reserves are in a relatively stronger position at the onset of a global recession and slowdown in trade.

Concentrated mostly in middle-income countries and energy exporters, reserve accumulation has been considerable. It has contributed to channel global savings to the United States, rather than to poor countries that were badly in need of capital to finance the expansion of public and private investment. LDCs have also greatly increased their accumulation of reserves, which amounted to 12.4 per cent of their GDP in 2006, up from 7.1 per cent in 1995–1999 (UNCTAD, 2008a: 24–25).

Even when ODA was rising since the turn of the millennium, it was merely compensating for its decline during the 1990s.

In addition to the large stockpiling of reserves, the IMF study also found that 58 per cent (37/64) of the non-reserve financing available for fiscal expansion had been diverted to paying off domestic debt. During the 1990s, when ODA was falling, low-income countries — and LDCs in particular — understandably had to resort to other means to finance government expenditures. Domestic debt was a major option. But it provided only short-term relief, and it exacted high interest payments.

Even when ODA was rising, domestic debt was still demanding to be paid off, and so a significant proportion of ODA was apparently used for that purpose. It is ironic that ODA has been, in effect, merely compensating since the turn of the millennium for its decline during the 1990s.

The proportion of all countries in sub-Saharan Africa that have high real rates of interest has risen since the year 2000 to about 80 per cent.

If paying off domestic debt could have lowered real rates of interest in LDCs in sub-Saharan Africa, this would have certainly been an improvement. But interest rates remained high. The proportion of all countries in sub-Saharan Africa that have real rates of interest higher than 6 per cent has risen since the year 2000 to about 80 per cent. Moreover, the spread between deposit and lending rates of interest has remained wide.

Risk is one explanation for such wide spreads. The market power exercised by the small number of large and often foreign-owned banks that dominate the financial sector in LDCs is another. Unfortunately, as long as such high real rates of interest prevail and interest rate spreads remain wide, there is little prospect for accelerated capital accumulation, which has to be the driving force for long-term growth and development.

As long as high real rates of interest prevail, there is little prospect for accelerated capital accumulation, which has to be the driving force for long-term growth and development.

Thanks to externalities and complementarities associated with capital accumulation, ODA could play a pivotal role in helping countries break this gridlock. If it is allocated to key economic infrastructures with large spillovers, ODA may crowd in additional investment and trigger large supply responses. In turn, this would spur income growth, thereby strengthening the capacity of financial institutions to mobilize domestic savings.

Many LDCs remain highly dependent on ODA, particularly for financing public investment. But the extent to which ODA can influence domestic investment in developing countries depends on a number of factors.

There is continuing debate, for example, on whether ODA actually displaces domestic savings, and thus either has no net positive effect on domestic investment or serves to reduce it. Empirical investigation of this issue indicates that the impact of ODA depends, to some extent, on whether it is provided as grants or loans.

The impact of ODA depends, to some extent, on whether it is provided as grants or loans.

The thrust of empirical results suggests that ODA does not completely displace domestic savings. In other words, when savings are regressed on a set of independent variables, which usually include income per capita and the dependency ratio, as well as ODA, the parameter of the ODA variable ranges between -1 and 0. This implies that ODA is used to boost both consumption (which will lower savings) and investment.

However, such analysis neglects the fact that a significant proportion of ODA might not even be converted into the domestic financing of consumption or investment. A recent study of this issue, which was commissioned by the International Policy Centre for Inclusive Growth and which complemented the earlier findings of the IMF evaluation, found that a significant proportion of ODA was simply converted into a reverse capital outflow, either for debt repayments or for the accumulation of foreign exchange reserves (Serieux, 2009).

ODA does not completely displace domestic savings.

Based on panel data for 29 sub-Saharan African countries for the period 1965–2006, the Serieux study finds that 35 per cent of ODA was converted into capital outflows, while 24 per cent financed domestic investment and 41 per cent financed domestic consumption.

From 1974 to 1994, when ODA was continuously increasing, the percentage of ODA converted into capital outflows rose to 48 per cent, while 31 per cent of ODA financed domestic investment and 21 per cent financed domestic consumption.

ODA should be much more directly tied to the financing of domestic investment.

The study does not draw out the possible policy implications of these findings. But it is important to do so, because ODA should be much more directly tied to the financing of domestic investment, particularly in order to expand productive capacities and generate higher rates of growth.

The study speculates that in the 1990s, a significant proportion of ODA was being used to finance the payment of principal or interest on external debt (most of it being concessional debt). In more recent years, it appears that ODA has been increasingly directed into the accumulation of foreign exchange reserves, as the IMF study of the 1999–2005 period suggests.

In order for LDCs to be able to mobilize sufficient resources to finance investment and development-oriented expenditures and to continue making progress towards the MDGs, it is necessary that current levels of ODA not be reduced. In addition, since the current crisis has heightened the risks on many LDCs' remaining debt, they should receive more debt relief. Providing such relief is not likely to have a significant immediate impact on the budgets of donor countries. However, further debt relief should not simply be a substitute for additional ODA, nor should additional ODA be a substitute for needed debt relief.

Further debt relief should not simply be a substitute for additional ODA, nor should additional ODA be a substitute for needed debt relief.

Since a portion of ODA results in reverse capital outflows, it is important for Governments to institute some forms of management of the capital account in order to safeguard the resources that are made available, theoretically, for domestic investment. "Capital flight" is a serious problem for many LDCs. Therefore, some management of capital outflows (probably more than capital inflows) should be a priority. This issue is discussed in section E.2(a) of this chapter.

On the issue of whether the proportion of ODA available for domestic expenditures is used for consumption or investment, it is important to press for a number of reforms in the allocation of ODA. In recent years, in conjunction with the rise of national poverty reduction strategies, donors have skewed ODA towards the social sectors — towards health and education in particular. In the process, the proportion of ODA commitments devoted to financing essential economic infrastructure has nearly halved (UNCTAD, 2006: 28–32).

In recent years, the proportion of ODA commitments devoted to financing essential economic infrastructure has nearly halved.

It is misguided to try to pit ODA financing of social infrastructure against ODA financing of economic infrastructure. The MDG agenda should be building a consensus for increasing public investment in both areas. Nevertheless, it is true that economic infrastructure has been underfunded by Western donors in recent years, and this is part of the explanation for the lack of expansion of productive capacities in many developing countries. Without such expansion, economic growth is unlikely to accelerate to the levels that are necessary to generate the public revenue needed to finance both social services and economic services.

It has also been well documented that ODA is a variable and unpredictable source of development financing, especially compared to domestic revenue. Disbursements of ODA are even more variable than allocations. These problems point to the need to institute longer-term commitments of aid from both bilateral and multilateral donors.

Lengthening the time frame of the commitment of ODA would be necessary in order to help strengthen government capacities to mobilize domestic revenues. A "matching funds" approach could be a useful part of such a reform. Currently, donors often provide budget support when a Government specifies its expenditure needs and calculates the financing gap to be filled by ODA. Donors then promise to finance the revenue shortfall that is identified. But such an approach can lead to government disincentives to raise domestic revenue. It is also likely to lead to the downscaling of ambitions for national development plans with respect to the potential represented by the promised higher ODA inflows (UNCTAD, 2008a: 119–120).

Lengthening the time frame of the commitment of ODA would be necessary in order to help strengthen government capacities to mobilize domestic revenues.

A better option would be to have donors agree to match a percentage of the funds collected by the Government, up to a fixed limit (Di John, 2008). This limit could be reduced over time, as the Government increases its capacity to raise domestic revenue. One of the advantages of such an approach is that Governments would have an incentive to raise more revenue, since that would lead to additional inflows of ODA.

C. Monetary and financial policies

1. Alternative monetary policies

Monetary policy has tended to dominate all other macroeconomic policies, and have been focused on maintaining macroeconomic stability, not on promoting growth, employment or exports.

Conventional macroeconomic policies give the leading role to monetary policies, over both fiscal and exchange rate policies. This is surprising, since monetary policies tend to be congenitally ineffective in the absence of developed financial sectors, as found in many developing countries and, most of all, in LDCs.

For conventional macroeconomics, the overriding function of monetary policies is to contain inflation at low levels. This is considered to be essential in order to foster a conducive business climate. Until recently, the prevailing target for inflation rates tended to be set at below 5 per cent. More recently, in discussing low-income countries in Africa, IMF has acknowledged that inflation in the range of 5–10 per cent is unlikely to have an adverse impact on growth.

The main policy tool to influence the inflation rate has been the policy interest rate of the central bank. In practice, interest rate policies have tended to dominate all other macroeconomic policies, and have been focused on maintaining macroeconomic stability, not on promoting growth, employment or exports.

A spiral of output prices and wages is highly unlikely in LDCs, where surplus labour is abundant, trade unions are weak, and the economy operates at well below full capacity.

This stance derives in part from worries about raising expectations of even higher rates of inflation, which it is believed would lead to a self-reinforcing upward spiral of output prices and wages. However, such a spiral is highly unlikely in LDCs, where surplus labour is abundant, trade unions are weak, and the economy operates at well below full capacity.

For conventional macroeconomics, inflation is assumed to originate in the monetization of fiscal deficits. It is not assumed to have any structural roots that the market cannot resolve. Hence, there is a bias towards maintaining high real rates of interest and containing wage pressures (particularly those of public sector workers).

The great majority of LDCs have only moderate rates of inflation.

Between 2000 and 2007, LDCs from all regions for which data are available not suffer from inordinately high rates of inflation. Out of 47 LDCs, for which data are available, the average consumer price index (CPI) inflation rate for 2005–2007 was above 15 per cent in only five countries — Angola, Eritrea, Guinea, Myanmar, and Sao Tome and Principe (table 7). The great majority of LDCs have only moderate rates of inflation (less than 15 per cent). Thirty-four of them had average rates for 2005–2007 that were below 10 per cent. The average CPI inflation rate for all LDCs during 2005–2007 was 9.8 per cent. It reached similar levels in African and Asian LDCs, while island LDCs had the lowest average (4.5 per cent).

There is virtually no empirical evidence that an inflation rate below 15 per cent has any adverse impact on economic growth.

There is virtually no empirical evidence that an inflation rate below 15 per cent has any adverse impact on economic growth (Pollin and Zhu, 2006). Above 15 per cent, there is some dispute as to whether growth will be adversely affected. But it is somewhat misleading to focus the argument on such threshold levels. For practical purposes, what is often more important is the source of inflation. Does it, for example, originate from the monetization of fiscal deficits? Is it accompanying a period of rapid growth, in which investment demand is driving the momentum? Or is it due to supply shocks, whether domestic or external?

It is important to understand the sources of inflation because the policy responses might differ. A recent study of 28 countries in sub-Saharan Africa

Table 7

Consumer price inflation in the LDCs, 2005–2007

(Per cent, period averages)

Afghanistan	8.2
Angola	15.8
Bangladesh	7.5
Benin	3.5
Bhutan	5.1
Burkina Faso	2.8
Burundi	7.4
Cambodia	5.4
Central African Republic	3.8
Chad	2.6
Comoros	3.2
Djibouti	3.4
Equatorial Guinea	5.3
Eritrea	17.4
Ethiopia	14.3
Gambia	3.0
Guinea	30.0
Guinea-Bissau	3.2
Haiti	13.2
Kiribati	-0.4
Lao People's Democratic Republic	6.5
Lesotho	5.8
Liberia	8.3
Madagascar	12.9
Malawi	12.5
Maldives	3.6
Mali	2.9
Mauritania	8.3
Mozambique	10.2
Myanmar	20.9
Nepal	6.9
Niger	2.3
Rwanda	9.0
Samoa	2.6
Sao Tome and Principe	19.5
Senegal	3.1
Sierra Leone	11.5
Solomon Islands	8.6
Sudan	7.5
Timor-Leste	3.8
Togo	3.2
Tuvalu	2.3
Uganda	7.3
United Republic of Tanzania	7.5
Vanuatu	2.4
Yemen	14.8
Zambia	12.2
LDCs[a]	**9.8**
Africa and Haiti	*9.7*
Asia	*10.0*
Islands	*4.5*

Source: UNCTAD secretariat calculations, based on data from the GlobStat database and the United Nations/DESA Statistics Division.

a Countries weighted by GDP for all groups of countries.

found, for example, that inflation arose mostly from supply shocks, the inertial momentum of initial increases in inflation, and sharp exchange rate depreciations (Heintz and Pollin, 2008). The sharp increases in food and oil prices in 2008 are a recent example of an external supply shock. Responding effectively to such shocks is likely to require policies that are not focused on interest rates or on inflation targets. Such shocks frequently cause prices to breach the low inflation targets set by central banks. So, inflexibly attempting to maintain such targets will be counterproductive. Policymakers should look for other means.

A policy bias towards raising interest rates stubbornly persists among central bankers.

For example, if there were an external shock to food prices, LDC Governments could respond with food relief if they had maintained a buffer stock of strategic grains — or had access to international stocks. If there were a shock to oil prices, Governments could provide temporary subsidies for electricity supply or public transportation (Pollin et al., 2006).

Would raising interest rates under such circumstances improve economic performance? It is more likely that such a response would not only slow economic growth further, but would also exacerbate inflation in the short term by making credit more expensive. And yet, a policy bias towards raising interest rates stubbornly persists among central bankers. This bias often goes hand in hand with an effort by finance ministries to contain fiscal deficits to low levels. Both policies would dampen aggregate demand.

Interest rates in the great majority of LDCs significantly exceed what would be conducive to investment-driven growth...

High real rates of interest still prevail in low-income countries and LDCs in sub-Saharan Africa. In the period from 2004 to 2006, for example, 27 out of a sample of 32 LDCs had *real* rates of interest of 6 per cent or above (table 8). Given that the real rate of interest is supposed to be roughly equivalent to the long-term sustainable rate of economic growth, the interest rates in the great majority of LDCs significantly exceed what would be conducive to investment-driven growth.

... and tend to be growth-dampening, because they raise excessively the cost of credit for both public and private investment.

For all LDCs during 2004–2006, the average real rate of interest was 9.0 per cent. For African LDCs it was significantly higher, at 10.1 per cent. For Asian LDCs, the average real rate was 7.6 per cent, and for island LDCs it was 9.2 per cent. For the sake of comparison, in high-income OECD countries, the corresponding real interest rate over the same period was lower than 4 per cent in 12 out of a sample of 16 countries.

Such high rates as those in place in LDCs tend to be growth-dampening, because they raise excessively the cost of credit for both public and private investment. During a global economic slowdown, when many industrialized countries have already slipped into recession, such high real interest rates will surely worsen the economic conditions in LDCs.

The general stance of monetary policy should be to accommodate more expansionary, investment-focused fiscal policies.

The general stance of monetary policy should be to accommodate more expansionary, investment-focused fiscal policies. In general, monetary policies are simply ineffective at playing the leading role in macroeconomic management in the context of low-income countries or LDCs. This role should be played by fiscal policies.

The primary responsibility of monetary policy is to ensure that there are adequate increases in liquidity — i.e. growth of the money supply — to meet the growing demand for money as a result of rising incomes. This implies trying to maintain moderately low real rates of interest that will help alleviate the borrowing costs of both the private sector and the Government.

Table 8

LDCs with high real interest rate,[a] 2004–2006

(Per cent, period averages)

Group	Country	Real interest rate
Africa and Haiti	Gambia	24.5
	Haiti	23.2
	Angola	19.1
	Malawi	15.6
	Central African Republic	15.4
	Mozambique	11.8
	Uganda	11.6
	Madagascar	11.2
	Zambia	8.8
	Burundi	8.3
	Sierra Leone	8.1
	Lesotho	7.9
	Djibouti	7.8
	Liberia	7.5
	United Republic of Tanzania	6.8
	Mauritania	6.4
	Rwanda	6.2
Asia	Lao People's Democratic Republic	19.6
	Cambodia	11.3
	Bhutan	9.5
	Bangladesh	9.4
Islands	Sao Tome and Principe	19.2
	Maldives	12.0
	Comoros	8.4
	Solomon Islands	6.7
	Vanuatu	6.2
	Samoa	6.1

Source: World Bank, *World Development Indicators 2008,* CD-ROM.

a The lending rate is the bank rate that usually meets the short- and medium-term financing needs of the private sector. Real interest rate is the lending rate adjusted for inflation as measured by the GDP deflator. High real interest rates are those above 6 per cent per annum.

Such a policy stance, however, runs counter to the practice of inflation targeting, which, in either explicit or implicit form, prevails as the favoured option for central bankers in LDCs as well as in other low-income countries.

During the current global and economic slowdown, monetary policies should support the leading role of fiscal policies in trying to prevent a substantial fall in aggregate demand.

During the current global and economic slowdown, inflation in LDCs is not a major danger. Commodity prices have been declining, and they are projected to remain subdued for a few years. Price inflation is falling dramatically in many industrialized countries, and there is a distinct concern in some of them that deflation, i.e. falling price levels, will soon set in.

Under such circumstances, monetary policies should support the leading role of fiscal policies in trying to prevent a substantial fall in aggregate demand. In other words, monetary policies should operate in a counter-cyclical fashion. If, instead, central banks insist on maintaining high rates of interest, monetary policies will operate pro-cyclically and will make any downturn even sharper and more protracted.

2. Why is monetary policy ineffective?

The initial contention of this section was that monetary policies are particularly ineffective in low-income countries, and in LDCs in particular. Many such countries might nominally possess the flexibility to use standard monetary instruments (such as open market operations, foreign exchange operations and interest rate policies), but they are unable to achieve their goals because of the underdevelopment of their financial systems (section D.1 of this chapter). The situation in most of the LDCs is that they have monetary policy in form but not in essence.

The situation in most of the LDCs is that they have monetary policy in form but not in essence...

Monetary policy can be represented, in simplified form, as the activity of the monetary authority (the central bank) to influence the amount of wealth invested in financial assets and to determine its distribution between money and public bonds. The central bank does this by buying and selling bonds and by acting as a price setter, through its policy interest rate.

For this activity to be effective, a viable market for public bonds must exist. Even in the most developed countries, relatively few households own bonds. In general, the vast majority of bonds are held by private banks and corporations (both national and international). Hence, an efficient bond market — the necessary prerequisite for an effective monetary policy — requires a burgeoning financial and corporate sector.

... since they are unable to achieve their goals because of the underdevelopment of their financial systems.

LDCs, however, do not have these sectors. Financial sectors in LDCs tend to be dominated by a few banks, which are usually foreign-owned. Large non-financial corporations are typically restricted to the extractive sectors — especially petroleum and minerals. In some countries, there might also be a limited number of large non-extractive enterprises, as well as high-income households, seeking financial forms in which to hold their wealth.

In LDCs, the banks (even if they are nationally owned), corporations, and wealthy households will not, taken together, create the basis for an efficient bond market. Foreign bonds — especially from the developed countries — offer a more secure form of wealth, and they can be easily exchanged in world markets, whereas LDC bonds cannot.

LDC financial sectors tend to be dominated by a few banks, which are usually foreign-owned.

There are two mechanisms that the central banks in LDCs could use to create a market for bonds, but both of them undermine the effectiveness of monetary policy. The first is to set the interest rate on government bonds high enough to induce large financial and non-financial corporations to purchase them. This mechanism negates the use of monetary policy to reduce fluctuations in the economy and to lay the preconditions for long-term growth. In effect, the bond rate is dictated by what is necessary to sell the bonds, not by growth or development objectives.

The second mechanism, which is very common, is to have regulations that compel banks to hold a specified portion of their assets in the form of government bonds. But this creates an involuntary demand for bonds, not a market. If the two mechanisms are used together, the central bank could discover that it faces the worst of all worlds: a non-functioning bond market with interest rates that both discourage private investment and create a large debt service burden for the public budget.

In LDCs, the banks, corporations, and wealthy households will not, taken together, create the basis for an efficient bond market.

The central bank could seek to affect interest rates directly, but with an inefficient bond market this is unlikely to be successful. For example, the purpose of lowering the central bank rate is to lower the cost for banks when they borrow from the central bank. This should induce the banks to pass on the reduced rate to their borrowers. In turn, the borrowers should increase their planned investments and borrowing and so stimulate an expansion of the real economy.

There are several reasons why this sequence of events is unlikely to occur in LDCs, or in many low-income countries. The commercial banks might not borrow from the central bank when they need additional funds, but rather from abroad. The banks often have excess funds, which they do not lend because they consider the rate of return to be too low or the risks of lending too high. Or else, most businesses and households are unable to borrow from the banks because they lack the formal characteristics that banks require (such as business records in standard accounting form).

Banks often do not lend because they consider the rate of return to be too low or the risks of lending too high.

In summary, financial institutions in LDCs tend to mirror their environment: they are underdeveloped and ineffective. Their revenue derives disproportionately from holding government bonds, not from lending for productive investment. Consequently, when they do lend, they ration credit to the "most creditworthy" and they tend to charge relatively high rates of interest.

The restrictive monetary policies of the central bank — which are likely to be wedded, for example, to targeting low inflation — only exacerbate the underlying structural constraints on financial institutions in LDCs.

Banks in LDCs tend to hold large amounts of excess liquidity, charge high lending rates of interest, and prefer short-term, risk-free government securities...

D. Reforming financial institutions to provide development finance

1. The financial sector in LDCs

The state of development of financial intermediation and of financial systems in LDCs was analysed in *The Least Developed Countries Report 2006* (UNCTAD, 2006: 230–246). It showed that banks in LDCs tend to hold large amounts of excess liquidity, charge high lending rates of interest, and prefer short-term, risk-free government securities. They are not inclined to engage patiently in long-term development-oriented lending at moderate rates of interest (Stallings and Studart, 2006). But it is precisely these forms of development finance that least developed countries need in order to maintain public and private investment, as well as some momentum in their growth rates.

... and are not inclined to engage patiently in long-term development-oriented lending at moderate rates of interest.

Households in LDCs are generally reluctant to hold their wealth in the form of financial savings. This is partly due to a lack of confidence in banking institutions. Hence, a major contribution of fiscal policy could be to finance financial reforms, such as instituting some form of deposit insurance to help instil such confidence.

Government policies would have to work on strengthening the capacities of financial institutions to support investment through the appropriate extension of credit, and to mobilize savings. The two functions could reinforce each other at the macroeconomic level. At present, however, there is a disjuncture between the two. Much of LDCs' investment is financed by ODA (or enclave FDI, such as that for oil extraction). At the same time, there is little motivation or capacity in the financial institutions to mobilize domestic savings.

Government policies should strengthen the capacities of financial institutions to support investment through the appropriate extension of credit, and to mobilize savings.

2. Mobilizing domestic savings in LDCs

Macroeconomic policies can play an important role — both directly and indirectly — in boosting income growth, thereby generating more domestic savings. Fast-growing developing economies typically have large investment ratios and improving current account balances, which translate into rising saving ratios

(UNCTAD, 2008b). The relatively good economic performance of LDCs during 2000–2007 implied rising domestic savings. However, with the onset of the global financial crisis and economic downturn, savings levels are likely to contract, along with incomes.

During 2000–2007, domestic savings rates in African LDCs rose appreciably — to over 16 per cent of GDP — double the levels of the 1980s and 1990s.

During 2000–2007, domestic savings rates in African LDCs did rise appreciably — to over 16 per cent of GDP — double the levels of the 1980s and 1990s (chart 12). The savings rate in Asian LDCs was slightly lower, at 15.5 per cent of GDP, but the rate in island LDCs dropped precipitously to under 5 per cent, from almost 15 per cent in the 1990s. However, behind all these averages, there was a mixed performance. The big jump in domestic savings in the period 2000–2007 was driven by trends in oil- and mineral-exporting LDCs (UNCTAD, 2008a: 9).

There is much that Governments in LDCs can do to strengthen the institutional and policy foundations for stimulating aggregate demand and income growth. While fiscal policies can have an indirect effect on savings through crowding in investment and boosting incomes, Government can also affect the real cost of investments by strengthening the intermediation role of credit and financial institutions. In most cases, LDCs have weak financial institutions, or have financial sectors that are dominated by a small set of foreign banks unwilling to undertake broad-based lending.

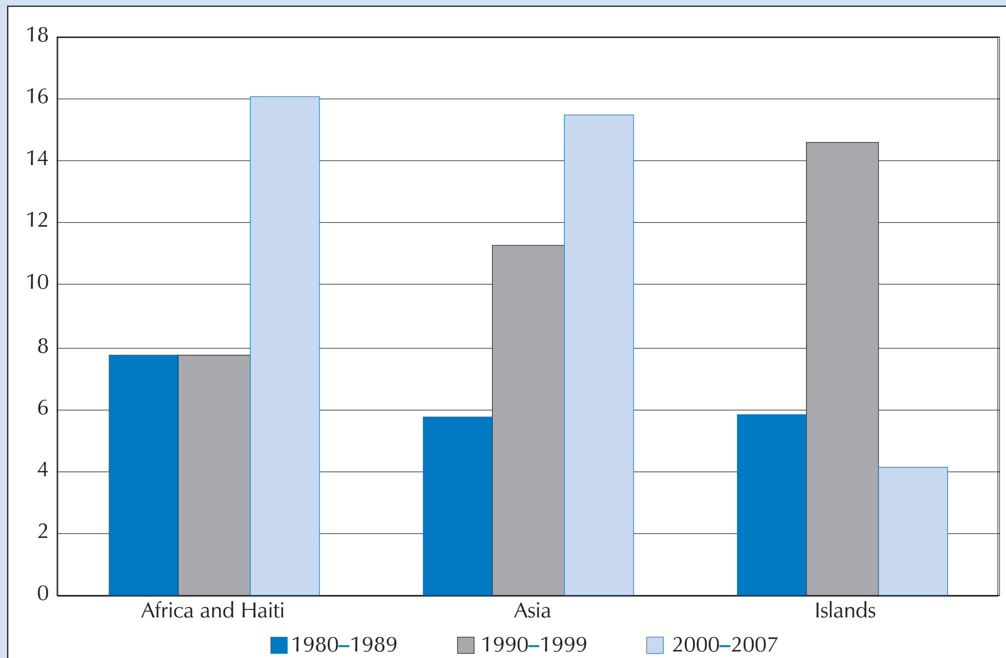
The savings rate in Asian LDCs was slightly lower, at 15.5 per cent of GDP.

3. Improving development finance

The major approaches to strengthening domestic financial institutions can be categorized in three ways. The first is to improve the market incentives of financial institutions to mobilize savings and channel them into public and private

Chart 12

Domestic savings in LDCs, 1980–2007
(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on data from the United Nations/DESA Statistics Division.
Note: Domestic savings are estimated as the differences between GDP and final consumption expenditure.

investment. The second is to link formal financial institutions with informal financial institutions, in order to broaden the base for both savings and lending. The third is to create or revive public institutions such as agricultural banks or development banks.

Governments can strengthen domestic financial institutions by providing public guarantees for a proportion of the loans offered by commercial banks.

(a) Market incentives

If Governments choose to rely on market incentives, one option would be to provide public guarantees for a proportion of the loans offered by commercial banks. Hence, such loans could carry a somewhat lower rate of interest. But, in return, borrowers would have to be held accountable for repaying such concessional loans. This would imply requiring borrowers to supply some form of collateral, and instituting monitoring and performance targets. To this end, borrowers could also be required to deposit part of the loan in an escrow account, which would be returned to the borrower upon repayment of the loan.[3]

The terms of such loans could be adjusted in order to ensure that the Government does not shoulder any substantial fiscal burden in backing them. A recent study in South Africa calculated that if one quarter of domestic investment were financed by such loans — and if the government guarantee covered only three quarters of each loan and the default rate were assumed to be 15 per cent — then the Government would face a cost of only 1–2 per cent of its annual budget (Pollin et al., 2006).

An alternative approach would be to institute differential asset-based reserve requirements on lending to different economic sectors.

An alternative approach, which could achieve similar objectives, would be to institute differential asset-based reserve requirements on lending to different economic sectors. Such requirements would enable Governments to motivate banks to lend to sectors that had strong growth or employment potential. The basic idea is that for loans to priority sectors, banks would be required to hold a smaller proportion of their assets as required reserves that have to be deposited in non-interest-bearing accounts at the central bank. Such latitude would enable banks to lend more to designated sectors. Frequently, differential reserve requirements have been used to correct general sectoral imbalances in investment; this means reducing loans to sectors with overinvestment, or increasing them to sectors with underinvestment.

A complement to such incentives could be explicit restrictions on lending to certain sectors or for certain economic activities. For example, some countries have established ceilings on the percentage of bank loans that support "non-priority" activities, such as real estate, securities trading, and offshore investments.

Developing a market for longer-term government bonds would allow financing public investment in infrastructure.

Banks in LDCs and other low-income countries often prefer to hold short-term government securities, because they are risk-free and pay a relatively high rate of interest. As well as exerting pressure on the budgets of LDC Governments, these instruments are inappropriate for financing public investment because of the high risk resulting from maturity mismatch over the medium term. One way of addressing this problem is to develop a market for longer-term government bonds. These would have longer maturities, and hence they would lower the liquidity risk. Such bonds would be more suited, for example, to financing public investment in infrastructure, which requires a longer gestation period and thus only generates revenue over the medium and the long term.

If lowering the average interest rate is a primary government objective, then the Government could attempt to enhance the competitiveness of the process by which its debt is marketed. One such method would be to institute public auctions of securities.

(b) Linking formal and informal institutions

A second approach to strengthening domestic financial institutions in order to mobilize savings for investment is to link formal institutions with informal ones. Although commercial banks frequently have excess liquidity, they are reluctant to lend because borrowers are perceived to be too risky or the transactions costs are too high. By contrast, informal financial institutions, such as rotating savings and credit societies, have more accurate information on borrowers' risks and can operate with lower transaction costs. But they lack the resources for extensive lending. A similar problem confronts many microfinance institutions and other small-scale financial institutions. In order for the linking of institutions to be successful, only well-established informal lenders, such as recognized lending associations, cooperatives or credit unions, should be involved in such programmes. Linking commercial banks with such institutions would also require formulating a broader regulatory framework that could incorporate informal institutions.

A second approach to strengthening domestic financial institutions is to link formal institutions with informal ones, which could improve opportunities to mobilize a larger pool of savings and to increase the amount of lending in LDCs.

If these two sets of institutions were linked in partnership, there could be improved opportunities both to mobilize a larger pool of savings and to increase the amount of lending in LDCs. A larger pool of private savings, drawn from lower-income households, could be monetized, and in turn, more loans could be extended to small-scale entrepreneurs and businesses. Commercial banks could extend their deposit base, and informal credit institutions could extend more loans to low-income borrowers.

(c) Organizing public finance institutions

A third major approach to strengthening the capacities of financial institutions in LDCs — particularly in order to direct credit to sectors with considerable growth and employment potential — is to revive public financial institutions. One such type of institution would be development banks, which used to be prevalent across developing countries.

A third approach to strengthening the capacities of financial institutions in LDCs is to revive public financial institutions.

Despite reported inefficiencies, they were often effective at performing the essential function of mobilizing and allocating long-term investment-focused development finance. Domestic commercial banks have been unwilling to undertake this function, particularly in the wake of financial liberalization.

Development banks were publicly financed and managed in countries such as Brazil, Japan and the Republic of Korea. They can also be organized as public–private partnerships, which could conceivably facilitate the raising of capital on international markets. Historically, such institutions have been the spearhead of the industrial policies and public investment programmes that have been critical to the accelerated growth of "late developing" countries. Where they have been successful, they have harnessed substantial domestic financial resources for development objectives.

Development banks can be organized as public–private partnerships, which could conceivably facilitate raising capital on international markets.

Their success was often attributable to the support of "developmental" central banks. Nowadays, most central banks focus on a narrow range of stabilization goals, and utilize a similarly narrow range of instruments, such as the short-term interest rate or the money supply. However, in earlier decades, central banks in many developing countries played a greater developmental role, helping development banks to promote sectoral and industrial development, and enabling the Government to foster a more rapid rate of economic growth (Epstein and Grabel, 2007). In China and India, for instance, the central bank was linked to the planning apparatus, in order to facilitate the allocation of medium- and long-term credit to industrial sectors. Consistent with the view that monetary policy is only

one part — and not necessarily the leading part — of economic policy, central banks were not established as independent institutions.

Agricultural banks are another public institution that it is worthwhile considering strengthening. Previously, they frequently offered an extensive network of rural outlets that could draw in savings from rural households, which enabled them to extend numerous agricultural loans. Commercial urban-based banks had little interest in financing agricultural activities, as these were regarded as being too risky. The financial liberalization undertaken by LDCs and other developing countries over the last 25 years has swept away much of the rural infrastructure associated with agricultural banks.

Agricultural banks and postal savings banks are other public institutions worthwhile strengthening.

Postal savings banks are a third type of public institution that could usefully be built up and expanded. Given that in many cases, post offices are a widespread institutional network in rural areas, they are a promising basis, especially in LDCs, for the mobilization of small-scale household savings.

(d) Investing in institutional capacities

Carrying out any of the three approaches outlined above would require a significant commitment of budgetary resources. In a sense, the resources could be regarded as financing investment in institutional capacities. Since such capacities would eventually enable the mobilization and allocation of a greater pool of domestic savings, the corresponding investment could have a relatively high social rate of return.

Since institutional capacities would eventually enable the mobilization and allocation of a greater pool of domestic savings, the corresponding investment could have a relatively high social rate of return.

A similar logic could apply to the deployment of ODA. Many LDCs will remain reliant on ODA for the foreseeable future, particularly during the current recession. But the medium- to long-term goal of LDCs — and also of external assistance — should be to progressively diminish such reliance on aid. With this in view, there is a compelling case for directing more ODA towards the strengthening of domestic financial institutions in LDCs along the lines presented above. In conjunction with helping Governments to mobilize more domestic revenue, assisting financial institutions to mobilize more savings would make a critical contribution to eventually eliminating the widespread aid dependency of LDCs.

E. Exchange rate and capital management policies

Current orthodoxy favours a fully flexible exchange rate regime ...

1. The need for complementary exchange-rate management

Managing the exchange rate is a corollary of expansionary fiscal policies and accommodating monetary policies. One of the purposes of such management is to diminish the probability of a rapid depreciation of the exchange rate due to an increase in inflation prompted by the impact of expansionary policies on demand.

... however, free-floating exchange rates have brought several difficulties to developing countries, including to LDCs.

Generally, current orthodoxy favours a fully flexible exchange rate regime, in which the rate is fully determined by the play of market forces. This is usually justified by claiming that historically, Governments have maintained overvalued exchange rates. However, free-floating exchange rates have brought several difficulties to developing countries, including to LDCs.

Exchange rate volatility is particularly troublesome for the macroeconomic stability of small economies that are heavily dependent on external trade.

Firstly, high degrees of exchange rate flexibility have led to an increased volatility of the nominal exchange rate, because of the inability of policymakers to respond effectively to frequent terms-of-trade or capital-outflow shocks. Containment of such shocks is an additional reason for reinstating some form of exchange rate management. Exchange rate volatility is particularly troublesome for the macroeconomic stability of small economies that are heavily dependent on external trade. By implication, it would be preferable for such countries to manage the exchange rate, instead of relying on domestic monetary policies to create an inflation anchor.

Secondly, when exchange rate flexibility is combined with inflexible inflation-targeting, the results can be especially destabilizing (Weeks, 2008). For example, when Zambia's exchange rate appreciated in the wake of its copper boom in 2005 and 2006, IMF conditionalities prevented the expansion of the domestic money supply because of the fear of rising inflation. But these conditionalities only exacerbated the negative fiscal effects of the appreciation, by lowering even further the domestic-currency equivalent of trade taxes and ODA. Hence, the Government's fiscal deficit widened unnecessarily.

Managing the exchange rate may allow countries to achieve broad-based export competiveness and greater structural diversification of the economy...

Thirdly, managing the exchange rate may allow countries to achieve — over the medium term — a rate that can foster broad-based export competiveness and can thereby lead to greater structural diversification of the economy. This is a strategic priority for LDCs, particularly because of their low level of export diversification. Achieving a stable and competitive exchange rate should take precedence over rigid monetary policy targets in such countries, because so much of their growth is dependent on both exports and imports.

... which can be achieved through a "managed float" or a "loose peg".

Management of the exchange rate can take various forms. Countries can implement a "managed float", in which the exchange rate is allowed to oscillate in accordance with market forces but the central bank intervenes by buying and selling reserves in order to contain the oscillations within a predetermined band. Alternatively, a country could adopt a "loose peg", which implies that the monetary authorities fix their domestic currency to the value of another currency (such as the dollar) or to a basket of currencies, but periodically adjust the pegged rate in order to maintain a competitive exchange rate.

Maintaining the competitiveness of exports is of paramount importance to LDCs. This is particularly important when such countries enjoy a boom in resource exports, as they did in 2007 and in the first half of 2008.

During 2004–2007, the great majority of LDCs continued to run current account deficits, and have now entered the global economic downturn at a distinct disadvantage.

Some LDCs have managed to improve their trade balance and their overall current account balance in recent years. During 2004–2007, for example, oil exporters such as Angola, Chad and Sudan, as a group, had a surplus of 4 per cent of GDP on their current account, whereas previously they had run deficits (table 9). Mineral exporters managed to reduce their current account deficits too, from 8.6 per cent during 2001–2003 to 6.4 per cent during 2004–2007.

However, with the exception of the small group of oil exporters, the great majority of LDCs continued to run current account deficits, and have now entered the global economic downturn at a distinct disadvantage. They will need greater capital inflows, principally of ODA, in order to finance such external deficits. Careful management of their exchange rates — in order to contain volatility and maintain some degree of export competitiveness — will therefore take on added importance.

Table 9

Current account and trade balances of LDCs, by groups, 1995–2007

(Per cent of GDP, period averages)

	1995–1997	1998–2000	2001–2003	2004–2007
Oil exporters				
Current account balance	-0.6	-6.3	-7.3	4.0
Balance of trade of goods and services	-4.2	-3.9	-0.1	9.8
Mineral exporters				
Current account balance	-4.9	-8.7	-8.6	-6.4
Balance of trade of goods and services	-10.1	-11.5	-11.9	-6.1
Agricultural exporters				
Current account balance	-5.6	-6.1	-7.1	-6.8
Balance of trade of goods and services	-13.2	-12.6	-13.3	-19.1
Other LDCs				
Current account balance	-3.5	-3.1	-1.6	-3.0
Balance of trade of goods and services	-10.0	-9.1	-7.2	-10.5

Source: UNCTAD secretariat calculations, based on data from IMF, *International Financial Statistics,* online (February 2009).

It has been argued that countries enjoying an increase of ODA could suffer from the effects of "Dutch Disease". The standard argument is that the supply of foreign exchange originating from ODA would lead to greater domestic demand — mainly through government spending — for non-tradable goods and services, and would therefore drive up their prices. Subsequently, such price increases would spill over into the tradable sectors, chiefly by raising input prices.

In many LDCs, there is widespread underutilization of factors of production, particularly labour, so the increased demand generated by government spending need not lead to a significant rise in the domestic price level.

Under a fixed exchange rate regime, the rate will appreciate in real terms as domestic prices rise relative to international prices. If the exchange rate is flexible, the greater demand for domestic currency — prompted by the increased supply of foreign exchange — would lead directly to an appreciation of the nominal exchange rate.

But higher inflation and appreciation of the exchange rate are not inevitable. Such effects depend on the extent of slack in the domestic economy and the success with which macroeconomic policies are managed and coordinated. In many LDCs, there is widespread underutilization of factors of production, particularly labour, so the increased demand generated by government spending need not lead to a significant rise in the domestic price level (McKinley, 2005).

Even if there were a rise in the price level, greater coordination of macroeconomic policies could succeed in managing any adverse effects. This implies that the increased government spending financed by the rise in domestic currency should be coordinated with the release of the corresponding foreign exchange reserves held by the central bank. Moreover, management of the exchange rate could also be used to mitigate any effects of appreciation on the competitiveness of non-resource exports.

In 2008–2009, LDCs confronted a series of developments that reinforce the need for some management of the capital account.

2. Managing the capital account

In 2008–2009, LDCs confronted a series of developments that reinforce the need for some management of the capital account. Although these countries have begun to experience increased inflows of FDI since the turn of the millennium, total capital inflows have remained modest. Moreover, as a consequence of the global financial crisis, FDI inflows are anticipated to decline. The chief problem that LDCs have to face is that of capital outflows originating in their own private sectors.

(a) The extent of capital flight[4]

Sub-Saharan Africa is a net creditor to the rest of the world.

It is difficult to make precise estimates of the scale of capital flight. However, Ndikumana and Boyce (2008) show that for a sample of 40 countries in sub-Saharan Africa during the period 1970–2004, the real stock of flight capital, calculated in 2004 dollars and including imputed interest, stood at $607 billion in 2004. That was $398 billion more than those countries' combined external debt. In other words, sub-Saharan Africa is a net creditor to the rest of the world.

Among the sample of 40 African countries were 26 LDCs. Their (unweighted) average stock of flight capital amounted to 129 per cent of their foreign debt. The stock of capital flight was considerably higher than the stock of foreign debt for most of them, particularly for oil producers and countries struck by conflict (table 10). By contrast, for six of the LDCs in the sample, the estimated capital flight was negative, which implies that inflows outweighed outflows during the period in question.

In 2007 and 2008, some LDCs enjoyed the benefits of the boom in primary commodity exports ...

The authors of these estimates also identify strong links between the scale of capital flight and the extent of external borrowing by African countries, sometimes with the knowledge of the international lenders themselves. Their policy conclusions include a call for better management of debt by African Governments, measures to prevent capital flight and repatriation of African assets from abroad.

LDCs are also subject to periodic volatility of portfolio investment. In 2007 and 2008, for example, some LDCs enjoyed the benefits of the boom in primary commodity exports; however, in some cases, this led to short-term inflows of "hot money" speculating that an appreciation of the exchange rate would result from the export boom. This phenomenon has been well documented in the case of Zambia, in respect of its copper boom which occurred somewhat earlier (Weeks et al., 2007).

... however, in some cases, this led to short-term inflows of "hot money" speculating that an appreciation of the exchange rate would result from the export boom.

During the unfolding of the global financial crisis in late 2008 and early 2009, some LDCs were also subject to the "flight to safety" phenomenon, in which private capital fled the financial markets of developing countries in search of less risky havens in rich countries. Thus, for example, in the London market, foreign investors in Uganda have converted a significant amount of the public and private debt instruments denominated in Ugandan shillings, which they had purchased earlier, back into dollars. Speculative capital has been flowing back into United States financial assets, particularly government securities, and this led to an appreciation of the United States dollar in late 2008. Although this appreciation could benefit LDC exports, it also has an adverse effect on the external debt of LDCs, which is denominated in dollars. Moreover, 12 LDCs have de facto pegs to the dollar, or manage a floating currency with the dollar as anchor.

During the unfolding of the global financial crisis in late 2008 and early 2009, some LDCs were also subject to the "flight to safety" phenomenon.

In the instances cited above, LDCs could benefit from some limited management of their capital accounts,[5] especially with regard to instituting disincentives to capital flight. Such management could be complementary to the management of their exchange rates. It is difficult to implement an independent monetary policy (and even fiscal policy) without some management of the capital account. This is particularly appropriate when a Government is pursuing a growth-oriented set of economic policies, which imply more expansionary fiscal and monetary policies.

A frequent irony is that progressive-minded Governments end up implementing conservative macroeconomic policies because of their fear of a fall in business confidence, which they believe would lead to a surge of capital outflows and a rapid depreciation of the exchange rate.

Table 10

Stock of accumulated capital flight over the period 1970–2004 in sub-Saharan Africa

(Per cent of the foreign debt stock in 2004)

	LDC	ODC
Angola	535.2	
Benin	-399.9	
Botswana		-207.4
Burkina Faso	369	
Burundi	185.3	
Cameroon		287.4
Cape Verde		523.6
Central African Republic	257.4	
Chad	137.9	
Comoros	-55.2	
Congo		299.8
Côte d'Ivoire		460
Democratic Republic of the Congo	310.3	
Ethiopia	342.6	
Gabon		289.1
Ghana		159.3
Guinea	29.6	
Kenya		93.3
Lesotho	117	
Madagascar	276.4	
Malawi	111.9	
Mali	-12.8	
Mauritania	174.4	
Mauritius		28.3
Mozambique	306.9	
Niger	-447.8	
Nigeria		670.9
Rwanda	355.7	
Sao Tome and Principe	292.4	
Senegal	-332	
Seychelles		485.7
Sierra Leone	406.6	
South Africa		176
Sudan	84.4	
Swaziland		285.6
Togo	-224.3	
Uganda	142.1	
United Republic of Tanzania	127.7	
Zambia	272.2	
Zimbabwe		511.9
Sample total	291.3	

Source: Ndikumana and Boyce (2008).

(b) The rationale for managing the capital account

It has been widely documented that the management of portfolio or other capital flows has contributed to the successful development of numerous emerging economies during their periods of take-off in growth. These include Brazil, Chile, China, Colombia, India, Malaysia, the Republic of Korea, and Taiwan Province of China.

The management of portfolio or other capital flows has contributed to the successful development of numerous emerging economies during their periods of take-off in growth.

In addition, nearly all the currently industrialized countries used capital management techniques at some point in their own development (Helleiner,

2003). In the two decades following the Second World War, for example, almost all industrialized countries (with the exception of the United States) tightly regulated inflows and outflows of portfolio investment. Continental European countries, as well as Japan, maintained stringent management of portfolio flows until the mid-1980s.

Since the experience with unregulated international flows of private capital during the Asian financial crisis in the late 1990s, multilateral and regional institutions have been more favourable to capital management techniques.

The following are some examples of specific measures that have been implemented by countries. Chile has established a one-year residence requirement for FDI or portfolio investment. Taiwan Province of China has tightly regulated FDI, foreign participation in its domestic stock market, and foreign borrowing by its residents. Singapore has had restrictions on swaps and other derivatives that could be used to speculate against its currency, and has refused to extend to non-residents credit that could be used for speculative purposes. Malaysia has restrictions on foreign borrowing, insists on a 12-month waiting period for repatriation of capital, and imposes graduated levies on capital outflows (which are proportional to the length of stay of capital in the country) (Epstein and Grabel, 2007).

Since the experience with unregulated international flows of private capital during the Asian financial crisis in the late 1990s, the International Monetary Fund and other multilateral and regional institutions have been more favourable to capital management techniques. Their preference, however, has been for market-based, temporary measures.

Grabel (2004) has argued persuasively for a system of what she calls "trip wires" and "speed bumps". "Trip wires" signal that a country is approaching high levels of risk on a particular dimension of private capital flows, such as the danger of a rapid outflow of portfolio investment. An example of a "trip wire" indicator would be the total accumulated foreign portfolio investment in a country expressed as a ratio to its gross equity market capitalization. When the ratio reaches a level that is considered to be too high, a graduated series of "speed bump" measures could be triggered — well before a crisis develops — and could check the inflow of new portfolio investment until the ratio recedes from critical levels.

LDCs are subject to continuous capital flight.

Such an approach might prove to be applicable in LDCs. As Ndikumana and Boyce suggest, LDCs are subject to *continuous* capital flight, carried out mostly by their political and economic elites, and often associated with external borrowing. Since many LDCs are major exporters of primary commodities, including highly valued items such as oil, copper or other minerals, they can also be subject to periodic speculative inflows and outflows of portfolio capital.

The most appropriate capital management techniques for LDCs are those that can slow down the outflow of speculative portfolio investment.

Thus, the most appropriate capital management techniques for LDCs are those that can slow down the outflow of speculative portfolio investment. These could include residence requirements of one year (or even less) before such investment flows could be taken back out of the country. Stricter regulations, starting with transparency of accounting, would have to be applied to inflows associated with external borrowing. These would have to include provisions to ensure that the borrowed funds actually entered the country.

Another reason for much closer surveillance and control of the capital account is the evidence, quoted earlier, that a significant proportion of ODA, on which LDCs are critically dependent, is converted into outward capital flows in the form of debt repayment, accumulation of foreign exchange reserves and capital flight.

Notes

1 In order for agricultural policy reform in donor countries to have generally positive impacts on LDCs, it would have to be sequential and take into account both LDCs' products of export potential, and the fact that two thirds of these countries are net food importers (UNCTAD, 2008a: 20-21). For a discussion on the prospects of trade and subsidy policy in the field of agriculture, see Stiglitz and Charlton (2005).

2 For instance, a similarly tight approach to fiscal policy informed the well-known Maastricht "parameters" of 60 per cent for the debt-to-GDP ratio and 3 per cent for the deficit-to-GDP ratio.

3 For instance, Benavente, Galetovic and Sanhueza (2006) present evidence about the public FOGAPE loan guarantee programme in Chile, suggesting that it has increased access to credit for high-quality firms.

4. "Capital flight may be defined as transfer of assets denominated in a national currency into assets denominated in a foreign currency, either at home or abroad, in ways that are not part of normal transactions." (OECD et al, 2002: 206). Boyce and Ndikumana (2008) estimate it as the change of a country's stock of external debt (adjusted for cross-country exchange rate fluctuations), plus net FDI, minus the current account deficit, minus the change in the stock of international reserves, plus net trade misinvoicing.

5. Capital account management is intended here as the set of regulations and measures implemented by public authorities aimed at reducing capital flows volatility, thus discouraging capital flight.

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