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**Rethinking Monetary and Financial Policy:  
Practical suggestions for monitoring financial  
stability while generating employment and  
poverty reduction**

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## Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*<sup>1</sup> which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work<sup>2</sup>, in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.<sup>3</sup>

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.<sup>4</sup>

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

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<sup>1</sup> See [http://www.ilo.org/public/english/bureau/dgo/download/dg\\_announce\\_en.pdf](http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf)

<sup>2</sup> See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

<sup>3</sup> See <http://www.ilo.org/gea>. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work*, "Vision" document, ILO, 2006.

<sup>4</sup> See <http://www.ilo.org/employment>.



## Foreword

The landscape of development is changing for all countries as a result of the impact of the global financial crisis, and in this context policy discussions in developing countries are increasingly focusing on optimizing policy responses.

Policy responses are included within, and also influence the shape of national Development Frameworks. In this regard, ILO has intensified its engagement in National Development Frameworks, including Poverty Reduction Strategies since 2001. Originally this was in response to limited participation of the ILO tripartite partners in the formulation process of these frameworks, and the limited emphasis laid on employment and decent work in the goals, strategies and budget allocations in many countries. More recently it has been also in relation to the crisis and the capacity for response. In fact, many countries are re-thinking their approaches in light of the impact of the financial crisis, and are seeking to clarify the range of policy options which can intensify employment outcomes as well as reduce poverty.

In doing this ILO has developed a practical approach applied to a varying degree in 39 countries across the globe. This approach has consisted of (i) engaging in policy discussion (ii) empowering constituents (separately and together) to better influence the drafting, implementation and monitoring of national frameworks and (iv) maintaining critical dialogue at national and international levels for making employment a central concern of the national development. The application of this approach is backed by a range of tools and analytic papers connecting the Decent Work Agenda with the PRS framework.

Improvement in tripartite participation has been evident although the process of capacity building continues. As part of this capacity building, a seminar, *Decent Work Issues in Poverty Reduction Strategies (PRSs) and National Development Frameworks*, was organized in Turin to consider priorities for the way forward.

This paper, first presented at the above mentioned seminar, is an important contribution to the new thinking and priorities on the role of monetary and fiscal policies, and their impact on employment and poverty reduction

We would like to thank Professor Gerald Epstein for this thought provoking paper and the presentation and discussion that he led at the Turin workshop.

This paper provides important ideas about the wide range of policy options available for adaptation to specific country contexts. It is a milestone in re-thinking the monetary and fiscal policy landscape, the role of the State and of the Central Banks in maximizing the employment impact of various policy instruments.

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## Acknowledgments

This Working Paper was first presented to a workshop organized by the Employment Policy department of the International Labour Organisation in December 2008 focused on *Decent Work Issues in Poverty Reduction Strategies (PRSs) and National Development Frameworks*. It formed part of a series of analytical presentations on making employment central in national development frameworks.

I would like to thank Mr. Jose Manuel Salazar-Xirinachs and Azita Berar Awad of ILO for their extensive and excellent comments on the first draft of this paper, and to Alana Albee and Graeme Buckley for reviewing subsequent drafts. Many thanks go also to my colleagues Ilene Gabel, James Heintz, Jomo, K.S., Leonce Ndikumana, Robert Pollin and Erinc Yeldan who have co-authored the papers or co-organized the projects on which most of the work presented here is based. Of course, I alone am responsible for the particular formulations presented here.

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## 1. Introduction

As the world financial crisis deepens and spreads to the real economy in more countries around the globe, many societies in the developing world that were already experiencing high levels of poverty and underemployment are now threatened to an even greater extent. The World Bank has estimated that the increased prices of food and fuel in the first half of 2008 have driven 100 million more people into poverty, world wide. And, now, with the global economic crisis spreading, the situation for poor people in the developing world could become much, much worse. In its January, 2009 forecast, the IMF predicted that World economic growth in 2009 would be only ½ percent, the lowest level since World War II, and turning negative if measured at market exchange rates. (<http://www.imf.org/external/pubs/ft/weo/2009/update/01/pdf/0109.pdf> ) The ILO Employment Trends Report, issued in January, 2009, warns that: "global unemployment in 2009 could increase over 2007 by a range of 18 million to 30 million workers, and more than 50 million if the situation continues to deteriorate....in this last scenario some 200 million workers, mostly in developing economies, could be pushed into extreme poverty." ([http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms\\_101461.pdf](http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_101461.pdf) )

In this environment, the task of generating substantially higher levels of decent employment has taken on more urgency, yet now faces even more obstacles than before. Of course, a key component of the solution to the current crisis will be massive expansionary fiscal actions on the part of the rich countries, preferably in a coordinated fashion, but individually if necessary. More aid and support from the rich countries and international institutions to the developing world will also be necessary to avoid a very serious, negative shock for the world's poorest and most vulnerable. In the short and medium run, as before the recent crisis, the key will be to generate large scale increases in decent work if developing countries and the world are to avoid a downward spiral into depression.

But what macroeconomic policy frameworks should be used to design policies to address this crises both in the short and in the medium terms? There seems little doubt that the conventional wisdom on macroeconomic and financial policy that has been promoted by the International Monetary Fund, World Bank, many Central Banks, Ministries of Finance, Treasuries and many economists around the globe for the past twenty-five years has now been shown to be profoundly flawed, if not totally discredited. This "neo-liberal" approach –the so-called "Washington Consensus" and its cousins -- that has promoted wide-spread financial de-regulation, elimination of capital controls and other capital management techniques, the obsession with attracting foreign capital no matter how short term or speculative, and inflation-targeting central bank policy that has focused on limiting commodity inflation to the low single digits while ignoring asset price inflation and employment creation, has not only been inadequate to solving the financial problems we face, but, very likely, were major contributors, if not the cause, of the financial crisis that the world is now confronting. Yet, despite the widespread loss of confidence in this model of macroeconomic management, many of the same institutions and economists are calling for a two track system: Non-orthodox policies of nationalization/bail-out, loose monetary policy and fiscal stimulus for the rich countries, and more of the same neo-liberal policies for the poorer countries.

What is clear is that to design and carry out these employment-oriented macroeconomic policies, the old orthodoxy must be abandoned, and policy makers must look for other policy frameworks to inform their macroeconomic and financial policies. Fortunately, these other frameworks and policies do exist, have been used by many successful countries for many years, and can be adapted to the current environment in many countries. Of course, they must be re-designed and made appropriate to the particular countries and issues involved. Among other factors, it is important to ensure that these

policies are designed to an appropriate level of economic development faced by each country. The main point, though, is that, on the whole, these policies and frameworks do not need to be invented whole cloth.

In this paper I summarize employment oriented macroeconomic and financial policies that governments in developing countries can adopt to help promote more and better employment as a key to reducing poverty over the medium to long run.<sup>5</sup> This paper is a companion paper to that of my colleague James Heintz (2008) who focuses primarily on informal employment.<sup>6</sup> In this paper, I will present policies within a more general framework which, in the case of informal employment issues, may need to be focused and adapted in the ways that James Heintz has described. Here I will focus on policies in three main areas: first, this paper will address issues of monetary policy. After presenting a critique of orthodox "inflation-targeting" monetary policy, I will describe concrete alternatives, based on a project conducted with an international team of economists, designed to help promote decent employment and poverty reduction.<sup>7</sup> Next I will turn to financial structure and policy and describe concrete alternative financial policies and structures that can help promote better credit access for small businesses and poor households, and more employment generating investment. Finally, I discuss policies for managing capital flows and exchange rates to help generate more and better employment. In addition, these policies, like those concerning the financial sector, will also help maintain financial stability, and avoid the kinds of financial meltdowns we have been witnessing in recent years, first in the developing countries, and now in the developed ones.

Before describing specific alternatives, we have to clarify what we mean by pro-employment and poverty reducing financial and macroeconomic policies. We will describe policies and institutions that are designed to maintain aggregate demand, mobilize and channel savings, allocate credit in accordance with identified social and economic objectives, and promote financial and macroeconomic stability with the goal of promoting growth that will generate employment, income and wealth for the majority, including the poor.

With these general principles in mind, we can now move on to our discussion of the three specific policy areas: 1) Monetary Policy 2) Financial Policy and 3) Exchange rate policy and the management of capital flows.

## **2 Monetary Policy**

### **2.1 Orthodox Policy: Inflation Targeting by central banks**

Despite the massive challenges facing the unemployed, underemployed and the poor, for the past decade or more, so-called "global best practice" approach to central banking has not focused on economic growth or employment generation; instead, it has pursued formal or informal "inflation-targeting", in which keeping a low rate of inflation – in the low single digits – has been proposed as the dominant and often exclusive target of monetary policy.

<sup>5</sup> This paper draws liberally from my work and the work of my colleagues. See Epstein (2000), Epstein and Grabel (2006), Epstein, Grabel and Jomo (2003) Heintz, (2008), Pollin, et. al. (2006), Pollin et. al. (2008).

<sup>6</sup> James Heintz, "Employment, Poverty, and Economic Policy in the Context of Widespread Informality", Paper Presented to the ILO, Turin, December, 2008.

<sup>7</sup> Most of the papers from this project are published in a special issue of the *International Review of Applied Economics*, March, 2008, edited by Gerald Epstein and Erinc Yeldan.

In this inflation-focused monetary policy, other important goals, such as financial stability, rapid economic growth and employment creation, are seen as inappropriate direct targets of central bank policy; rather they are viewed as hoped for – even presumed – by-products of an inflation focused approach to monetary policy. (IMF, 2006). Thus, according to this orthodox approach to monetary policy, the focus of policy is on "stabilization", rather than "growth" or "development", with an implicit assumption that once "stabilization" is achieved, economic growth, employment creation, and poverty reduction will follow.

This orthodox view not only specifies the appropriate target of monetary policy, but also the appropriate tools or instruments. The orthodox approach has emphasized indirect, market based instruments of policy, such as short term interest rates, as the primary and often exclusive tool of monetary policy. This is in contrast to the 'direct', quantitative tools often used by central banks which have involved credit allocation methods, interest rate ceilings, and other ways to direct credit to priority economic sectors and goals. In short, the orthodox approach has narrowed both the goals and the tools of monetary policy.

After more than a decade of experience with this inflation-focused, market based approach, the policy record has been rather disappointing, even disastrous for many countries. In a number of countries, inflation has come down, to be sure, but it is questionable to what extent the drop in inflation is due to changes in domestic monetary policy, rather than the overall global fall in inflation (Ball and Sheridan, 2003). But even if domestic monetary policy *has* reduced inflation, the hoped for gains in employment have, generally, NOT materialized; and, for many countries following this orthodox approach, economic growth has not significantly increased. And this assessment does not even take into account the disastrous impact of the global economic crisis of 2007 - ?, that, arguably, are exacerbated, if not caused, by some of these same policies. The key point, then, is this: despite what the orthodox approach maintains, employment generation and economic growth, are NOT automatic by-products of "stabilization-focused" central bank policy.

While it might seem obvious that stabilization focused central bank policy represents the only proper role for central banks, in fact, looking at history casts serious doubt on this claim. Far from being the historical norm, this focus by central banks on stabilization to the exclusion of development represents a sharp break from historical practice, not just in the developing world but also in the now developed countries as well (Epstein, 2007a). In many of the successful currently developed countries, as well as in many developing countries in the post-Second World War period, development was seen as a crucial part of the central bank's tasks. Now, by contrast, development has dropped off the "to do" list of central banks in most developing countries

As the world digs itself out of this economic crises and establishes a new macro-economic framework, there should be a return to the historical norm of central bank policy: in particular, employment creation, financial stability and more rapid economic growth should join inflation and stabilization more generally as key goals of central bank policy. Of course, we do NOT argue that maintaining a moderate inflation rate is unimportant. Indeed, historically, some central banks went much too far in downplaying this stabilization role, sometimes with disastrous consequences: a prominent example is Zaire, which experienced numerous periods of disruptively high inflation (Honohan and O'Connell, 1997). But this does not mean that the optimal policy is to go to the other extreme and ignore the developmental role entirely. Balancing between the stabilization and developmental roles is both desirable and feasible for many central banks. Some of the policies undertaken by developmentally oriented central banks in the 1950's – 1970's were misguided or ill-executed: Ghana in the 1950's and 1960's is one example. (Honohan and O'Connell, 1997). Still, we can learn important lessons from their experiences and utilize them to re-orient central bank policy in relevant countries to a greater focus on employment creation as a desirable goal of monetary policy.

Of course, central banks need not, and indeed, *cannot* be the only institution having an employment generation role. Fiscal policy, industrial policy, labor policy and others must play a crucial role as well. But, in most developing countries, central banks need to cooperate with other institutions by doing much more than simply keeping inflation rates in the low single digits. To bring this about, many institutions will have to get involved. Among them is the IMF, which has been enshrining inflation control as a dominant policy. The IMF should change its advice to a more balanced position between inflation control and employment generation and poverty reduction.

## 2.2 A Critique of Inflation Targeting

Before discussing more employment friendly approaches to macroeconomic and monetary policy, it will be helpful to briefly discuss the problems with the now dominant approach – namely inflation targeting.

According to its advocates, "full fledged" inflation targeting consists of five components: absence of other nominal anchors, such as exchange rates or nominal GDP; an institutional commitment to price stability; absence of fiscal dominance; policy (instrument) independence; and policy transparency and accountability. (Mishkin and Schmidt-Hebbel, 2001, p. 3; Bernanke, et. al. 1999). In practice, while few central banks reach the "ideal" of being "full fledged" inflation targeters, many others still focus on fighting inflation to the virtual exclusion of other goals. The overriding announced goal of inflation targeting central banks is typically "price stability", usually defined to be an inflation rate in the low single digits. (Ibid., p. 99). In addition, inflation targeting is usually associated with changes in the law that enhance the independence of the central bank (Ibid., p. 102; Mishkin and Schmidt-Hebbel, 2001, p. 8). As we see below, this relatively rigid commitment to a very low inflation rate can lead to monetary policy that is too restrictive, leading to excessively high real interest rates, sub-optimal growth of GDP and employment, and an over-valued exchange rate.

The major claims made by advocates of inflation targeting is that it will:

- Reduce the rate of inflation
- Enhance the credibility of monetary policy
- Reduce the *sacrifice* ratio associated with contractionary monetary policy
- Help attract foreign investment and encourage domestic investment

The evidence on these claims is mainly in the negative. It is true that countries that adopt inflation targeting often achieve lower inflation rates. But there is strong evidence that this decline in inflation might not be due to inflation targeting itself, but rather to the general declines in world-wide inflation pressures, (due for example, to major increases of the global labor and increases in global production capacity due to extraordinary export-oriented growth in China and the fall of the Berlin Wall) or to a simple reversion to a more normal inflation rate (Ball and Sheridan, 2003; for a contrary view, though, see IMF 2006). In addition, most evidence indicates that inflation targeting central banks do not reduce inflation at any lower cost than other countries' central banks in terms of forgone output. That is, inflation targeting does not appear to increase the credibility of central bank policy and therefore, does not appear to reduce the sacrifice ratio. (See Bernanke, et. al, 1999 and Epstein, 2000, for detailed surveys of the literature). Typically, central banks that reduce inflation do so the old-fashioned way: by raising interest rates, causing recessions or slow growth, and contributing to job loss. Moreover, there is no evidence that countries adopting inflation targeting manage to attract more foreign investment.

## 2.3 Why the Focus on Inflation?

There is a further, basic problem with inflation targeting and the neo-liberal approach to central bank policy more generally. Why is there such a focus on fighting inflation to the

exclusion of other goals? And even if fighting inflation is important, as we agree it is, why pick a target in the low single digits? As reported in Bruno and Easterly (1996) and Epstein (2000) there is a great deal of evidence that moderate rates of inflation, inflation up to 20% or more, has no predictable negative consequences on the real economy: it is not associated with slower growth, reduced investment, less foreign direct investment, or any other important real variable that one can find. (Also see Pollin and Zhu, 2006). Some types of price increases, usually associated with "supply shock" inflation – especially those involving price increases for basic necessities, can have very serious negative consequences for the poor. But in this case, it is not clear that restrictive monetary policy is the best response. Acquiring more supply of the commodity "in shock" would generally be a preferable policy response.

Apart from growth effects, however, many economists have argued that inflation harms the poor more than the rich. Hence, on distribution grounds, inflation reduction into the low single digits should be a priority. While more research is necessary to fully investigate this claim, important recent work by Jayadev calls this conventional wisdom into question (Jayadev 2006, 2008) by showing that in a sample of richer and middle income developing countries, poorer and working class people prefer the government reduce unemployment than fight inflation. Only the wealthier people prefer that inflation fighting take precedence over lowering unemployment.

In addition to these concerns, Braunstein and Heintz (2008) find that disinflationary monetary policy in developing countries, like that undertaken in connection with inflation-focused monetary policy regimes, has a disproportionately negative employment effect on women, relative to men. Braunstein and Heintz conjecture that this might be due either to the sectors which tight monetary policy harm most directly. For example perhaps export sectors employ a higher ratio of women, and they are hurt disproportionately by tight monetary policy which raises interest rates, attracts foreign capital and leads to an over-valuation of the real exchange rate. Another possibility is that, because of discrimination, women are "first fired" in a recession. Both of these are just conjectures, however, and this empirical finding calls out for further explanatory research. Still, Braunstein and Heintz's excellent work is highly suggestive that there may be important gender effects of monetary policy, suggesting that this area needs much more research than it is currently receiving.

Of course, all agree that very high levels of inflation, above 40%, can have every serious impacts on growth and possibly the distribution of income. Even inflation above 20% can create problems, according to recent data. But there appears to be very little justification for monetary policy oriented toward keeping inflation in the low single digits, especially when employment and poverty are significant problems.

Still, it is important to recognize that some types of inflation unambiguously hurts the poor. Cost-push or supply side inflation of basic necessities, such as food, oil, and other basic supplies, can have devastating impacts on the poor. This type of inflation, in fact, is often the dominant type of inflation in most developing countries. However, it is unlikely that tight monetary policy, in and of itself, is the best response to this type of inflation. Efforts to increase supply, while controlling costs and subsidizing the consumption of the most vulnerable, perhaps by basic income grants, is often the best response to this inflation. Of course, it is important to take care that such supply-shock inflation does not lead to a cost-push price spiral that gets out of control. Monetary policy does have an important role to play in preventing such an inflation spiral getting out of control.

## **2.4 Inflation Targeting and IMF Financial Programming**

The problems associated with inflation targeting are exacerbated when they are combined with the standard restrictions the IMF imposes on borrowing countries' monetary policy. These standard restrictions are called *financial programming*.

The IMF financial programming approach has been subject to a number of significant criticisms (Epstein and Heintz, 2006; Easterly, 2004; Blejer et al., 2002). Easterly (2004) shows that there is significant empirical slippage in virtually every stage of the programming analysis, so that hitting ultimate targets becomes extremely problematic. As a result, the framework either routinely produces wrong results, or must be supplemented by other analyses that are not part of the programming framework. Partly as a result, the IMF has recently been imposing (or strongly recommending) additional targets, especially inflation targets (IT). Blejer et al. (2002) argue that inflation targets are redundant and sometimes inconsistent with the other IMF programming targets; Epstein and Heintz (2006) show that inflation targets enforce a contractionary bias on the regular programming targets, making it less likely that the central bank will accommodate economic growth and credit creation when desirable. Table 1 is reproduced from the Epstein and Heintz (2006) paper. In the traditional financial programming exercise, the main targets are net domestic assets ceilings (NDA, sometimes called “domestic credit ceilings”) which limit the amount of credit that the Central Bank can create, and the net international reserves floor (NIR), which require that monetary and fiscal policy are set to maintain a minimum level of international reserves. If either target is threatened – that is, if international reserves are too low or if net domestic assets are too high – then the program calls for tightening monetary policy, raising the target interest rate, cutting down on credit to the government and banking sector, and/or raising reserve requirements.

A key and troubling implication of this approach is that there is no clear set of conditions under which expansionary monetary or credit policies are called for, even in a situation of slow growth. Even if both targets are met, programming does not call for expansionary policy. This is largely because there is no explicit operational target for economic growth, employment creation, or poverty reduction. This could also reflect a priority placed on accumulating foreign exchange reserves over other goals, such as achieving more employment. In any case, the bias of financial programming is therefore contractionary.

**Table 1 IMF Financial programming based on net domestic assets ceilings and net international reserves floors**

		<b>Net Domestic Assets (NDA)</b>	
		<b>Higher Than Programmed (Threatened)</b>	<b>Lower Than Programmed (Not Threatened)</b>
<b>Net International Reserves (NIR)</b>	<b>Higher Than Programmed (Not Threatened)</b>	Only the NIR target has been met. <b>Policy: tighten</b>	Both targets have been met. <b>Policy: No need for tightening</b>
	<b>Lower Than Programmed (Threatened)</b>	Neither target has been met. <b>Policy: tighten</b>	NIR has not been met. <b>Policy: tighten</b>

Source: Epstein and Heintz (2006), adapted from Blejer et al. (2002), Table 1

If explicit inflation targets are added to the traditional financial programming exercise, then this bias becomes even worse, especially in a situation of supply-side inflation shocks. An inflation ceiling essentially adds an additional restriction on policy. Table 2 adapted from Blejer et al. (2002), illustrates this point. For example, in the situation where the NIR floor is met and NDA ceiling is met, but, say, because of a supply shock, the inflation target is not met, this approach would call for restrictive policy. Again, there is no situation which explicitly calls for looser policy because, as before, growth or employment generation does not have explicit targets within the monetary programming framework.



**Table 2 Financial programming with net domestic assets, net international reserves, and inflation targets**

		Inflation Target (IT)	
		Higher Than Programmed (Threatened)	Lower Than Programmed (Not Threatened)
Net Domestic Assets (NDA) Relative to Program Requirements	Higher Than Programmed (Threatened)	NDA and IT give the same signal. <b>Policy: tighten</b>	NDA and IT give different signals. (NDA – tighten; IT – don't tighten). <b>Policy: tighten</b>
	Lower Than Programmed (Not Threatened)	NDA and IT give different signals: IT – tighten; NDA – no tightening needed. <b>Policy: tighten</b>	NDA and IT give the same signal. <b>Policy: No tightening needed.</b>

Source: Epstein and Heintz (2006), adapted from Blejer et al. (2002), Table 2

None of this is meant to imply that maintaining a moderate and stable inflation rate is unimportant; nor are we arguing that the macroeconomic authorities can ignore supply-side inflation. But it does suggest that unless economic growth targets are explicitly incorporated into the making of macroeconomic policy, there will be a bias against growth and employment in IMF financial programming and as a result in recipient countries formulation of policy as it is currently structured.

## 2.5 Alternatives to Inflation Targeting

Fortunately, there are alternatives to inflation targeting that hold out the promise of a more employment friendly monetary policy and that can be tailored to the particular circumstances and needs of different countries. These were developed by a team of researchers working on a PERI/Bilkent project on alternatives to inflation targeting, as well as a United Nations Development Project (UNDP) sponsored study of employment targeting economic policy for South Africa.<sup>8</sup> The countries covered in PERI/Bilkent project are Argentina, Brazil, Mexico, India, The Philippines, South Africa, Turkey, and Viet Nam. As will be illustrated by these studies, one size does NOT fit all. A range of alternatives were developed in these papers, from modest changes in the inflation targeting framework to allow for more focus on exchange rates and a change in the index of inflation used, to a much broader change in the overall mandate of the central bank towards employment targeting, rather than inflation targeting. (See Table 3 below for a summary). Some of the alternative policies focus exclusively on changes in central bank policy, while for other countries, changes in the broad policy framework and in the interactions of monetary, financial and fiscal policy are proposed. Some incorporate explicit goals and targets, while others prefer more flexibility and somewhat less transparency. But all of the studies agreed that the responsibilities of central banks, particularly in developing countries, while including maintaining a moderate rate of inflation, must be broader than that, and should include other crucial "real" variables that have a direct impact on employment, poverty and economic growth, such as the real exchange rate, employment, or investment.<sup>9</sup> They also

<sup>8</sup> The project was directed by Gerald Epstein of the University of Massachusetts and Erinc Yeldan of Bilkent University, Ankara, Turkey. For the published papers of the PERI/Bilkent project see Epstein and Yeldan, eds. 2009. The PERI/Bilkent Project was made possible with the generous support of Ford Foundation, Rockefeller Brothers Fund, UN-DESA and other funders.

<sup>9</sup> It is true that so-called "Taylor Rules" that estimate policy rules governing monetary policy often find that central banks react to the deviation between "potential output" and actual output (the "output gap"), but, far from implying that central banks care about unemployment, these results can

agree that in many cases, central banks must broaden their available policy tools to allow them to reach multiple goals, including, if necessary, the implementation of capital management techniques (Ocampo, 2002; Epstein, Grabel and Jomo, 2006).

## 2.6 Real Targeting

The employment targeting approach is an example of a *real targeting* framework. A real targeting framework for monetary policy adds one or more important real variables, such as real GDP growth, or a stable and competitive real exchange rate (SCRER), or "full employment", to nominal variables, such as the rate of inflation, as a goal of monetary policy. The so-called Humphrey-Hawkins law in the United States, which commits the U.S. Federal Reserve (FED) to maintaining both "price stability" and "high levels of employment" is an example of a *real targeting* framework, though, admittedly a fairly weak one in that it does not specify exactly the meaning of "price stability" or "high employment".

A *real targeting* framework has a number of important advantages.

1. First and foremost, it places front and centre the economic variables that have the most immediate and clearest association with social welfare. The central bank must identify this target and then communicate with the public about the actions it is taking to reach it. It is hoped that, given the public pressure to reach this target, the central bank will have significant incentives to invest in research and other activities, to improve its understanding and tools to reach this real target.
2. Given that it will strive to reach this target amid other constraints, the central bank will have incentives to develop new tools of monetary policy. For example, if a central bank is tasked with hitting an employment target subject to an inflation and balance of payments constraint, then – in addition to interest rate policy - it might explore asset allocation strategies to encourage banks to lend more to high employment generating uses, and capital control techniques to manage balance of payments problems.
3. A real targeting approach lends itself naturally to a more democratic, transparent and accountable central bank policy that serves the genuine needs of the majority of countries' citizens, rather than the minority that typically benefits from the combination of slower growth, low inflation, and high real interest rates.
4. The framework is much more conducive to tailoring monetary policy to the specific needs of different countries. For example, if a country has a particular problem with generating good jobs for women, or more jobs in a particular region of the country, then the real targeting approach can accommodate such needs. Of course, the central bank will find it difficult to use "macroeconomic" tools to target particular groups or particular regions, but the central bank will have an incentive and permission to work with other ministries and the private sector to develop tools and mechanisms to improve employment opportunities for these groups and regions.

One important objection to a "real targeting" approach to monetary policy is the claim that monetary policy does not have control over real variables, especially in the medium to long-run. Of course, this is the position taken by orthodox (i.e., pre-Keynesian) macroeconomic theory, and incorporates the idea of the "classical dichotomy" in which nominal variables, like monetary variables, have no long-run impact on real variables, such as employment. There is very little support for this point view, and we are violently reminded every several years – at times of financial crisis – how wrong this view really is. As Keynes argued, the long run is made up of a series of short runs in which, monetary

be justified by noting that the output gap affects future inflation, so the central bank focusing solely on inflation would still be concerned with the output gap.

variables, including those controlled by monetary policy, can have very significant impacts on important real variables, such as employment and economic growth.

That is not to say that monetary policy can always easily *control* these variables with any precision. That is clearly not always true. Still, central bank policy, in combination with other types of macroeconomic and micro-oriented policies can clearly have important, broadly controllable, effects on these key variables.

In sum, the *real targeting approach* to monetary policy is likely to be more relevant, flexible and effective than inflation targeting. As a particularly relevant example of real targeting, employment targeting is described in more detail below.

## 2.7 Alternatives to Inflation Targeting:

Alternatives to inflation targeting developed in the PERI/Bilkent project on alternatives to inflation targeting are discussed here. Table 3 summarizes these approaches.

**Table 3 PERI/BILKENT Alternatives To Inflation Targeting Project**

Country	Ultimate Targets	Intermediate Targets	Strict Target or Discretion	Additional Tools/Instruments	Central Bank*: Independent, Integrated or Coordinated?
Argentina	SCRER <sup>10</sup> , inflation, activity level	Same as ultimate targets	Discretion	Sterilization, reserve requirements (other prudential requirements), capital management techniques	Coordinated
Brazil	inflation, exports, investment	Inflation rate SCRER, real interest rate		Asymmetric managed float (moving floor on exchange rate), bank reserves, bank capital requirements, bank capital requirements	NA
India	GDP Growth, inflation, slightly undervalued exchange rate	Same as ultimate targets	Discretion	Capital management techniques, if necessary	Integrated
Mexico	Inflation, SCRER	Domestic inflation measure, SCRER, "sliding floor" on exchange rate	Discretion	Capital Management Techniques	NA
South Africa	Employment, inflation, exchange rate instability	GDP Growth, employment intensity of production	Strict employment target (coordinated with other institutions), looser inflation constraint	Credit allocation techniques (eg. asset based reserve requirements, loan guarantees, etc.), capital management techniques	Integrated
Turkey	Inflation; SCRER	NA	Discretion	NA	NA
Philippines	Inflation; SCRER		Discretion	Capital management techniques; prudential supervision of banks; targeted credit; incomes	Integrated

<sup>10</sup> SCRER: Stable and Competitive Real Exchange Rate

			policies;	
Vietnam	Growth, SCRER, Inflation	Discretion	Capital management techniques; prudential supervision of banks; targeted credit; incomes policies;	Integrated

Source: see text;

NA: No Answer, i.e., the issue was not directly addressed.

\* Central Banks: Integrated means integrated into governmental macroeconomic policy making framework

Coordinated means independent but committed to close coordination with other macroeconomic policy-making institutions

The papers in the *Alternatives to Inflation Targeting* project present a range of alternatives: some are modest adjustments to the inflation targeting framework, others are more substantial modifications to the to approach, while still others throw out the inflation targeting framework in its entirety and provide a total alternative, such as *employment targeting*. We discuss many of these in the following paragraphs.

### 2.7.1 Modest but Useful Adjustments to the Inflation Targeting Regime

Some of the country studies in the PERI/Bilkent project proposed only modest changes to the inflation targeting regime. In the case of Mexico, for example, the authors argue that the inflation targeting regime has allowed for more flexible monetary policy than had occurred under regimes with strict monetary targets or strict exchange rate targets (Galindo and Ros, 2008), and therefore Galindo and Ros suggest modifying the IT framework to make it somewhat more employment friendly. In their analysis of Mexico's IT framework, Galindo and Ros find that monetary policy was asymmetric with respect to exchange rate movements –tightening when exchange rates depreciated, but NOT loosening when exchange rates appreciated. This lent a bias in favor of an over-valued exchange rate in Mexico. So Galindo and Ros propose a "neutral" monetary policy so that the central bank of Mexico responds symmetrically to exchange rate movements, thereby avoiding bias toward over-valuation without fundamentally changing the inflation targeting framework.<sup>11</sup>

In his study of Brazil, Nelson Barbosa-Filho also proposed extending the inflation targeting framework, but as we will see shortly, he also suggests altering it in a more dramatic way. Barbosa-Filho argues that because of Brazil's past experience with high inflation, the best policy is to continue to target inflation while the economy moves to a more stable macroeconomic situation. So far the great gain from inflation targeting has been the increase in the transparency and accountability of monetary policy in Brazil." (Barbosa-Filho, 2008). But he also suggests altering it to make the inflation targeting framework more compatible with fast income growth and stable public and foreign finance. Along these lines, as discussed in the next section, Barbosa-Filho joins a number of the country case study authors in proposing a monetary policy to maintain a stable and competitive real exchange rate (SCRER) which, they argue, will have a number of significant benefits.

<sup>11</sup> Galindo and Ros also propose shifting from a CPI target to a domestic inflation target which would purge the exchange rate impact on the "target" inflation rate and further reduce the basis for the monetary policy bias toward exchange rate appreciation.

## 2.7.2 A Competitive and Stable Real Exchange rate

As just indicated, a number of the authors, including Frenkel and Ros (2005) and Frenkel and Rapetti (2008) argue that central bank should maintain a moderate inflation rate AND should maintain a competitive and stable real exchange rate. They note that the real exchange rate can affect employment, and the economy more generally, through a number of channels: (1) by affecting the level of aggregate demand (*the macroeconomic channel*) (2) by affecting the cost of labor relative to other goods and thereby affecting the amount of labor hired per unit of output (*the labor intensity channel*) and by affecting employment through its impact on investment and economic growth (*the development channel*). (eg. Frenkel and Ros , pp. 634-637) While the size and even direction of these effects might differ from country to country, in many countries, including countries in Latin America, maintaining a competitive and stable real exchange rate is likely to have a positive employment impact overall. (Frenkel and Rapetti, 2008).

From the point of view of monetary policy, the challenge is how to design a policy to maintain a stable and competitive real exchange rate (SCRER ) so that it does not get undermined by massive speculative capital flows. The danger is that if the markets sees the central bank trying to manipulate the exchange rate, then the exchange rate will be subject to attacks that will undermine the ability of the central bank to prevent the currency from excessively appreciating or depreciating. (Frenkel and Rapetti, 2008) As discussed in more detail below, central banks can adopt various types of capital controls and other types of capital management techniques to help manage exchange rates in the face of speculative capital flows (Epstein, Grabel, Jomo, 2006). whereto do this, central banks may need to expand their of policy EDIT tools in order to try to achieve multiple targets.

## 2.8 A More Comprehensive Approach: An Employment Targeted Economic Program for South Africa

As part of a comprehensive macroeconomic program for South Africa (Pollin, et. al., 2006), Epstein developed an employment targeting framework for central bank policy to replace the Reserve Bank of South Africa's destructive inflation targeting approach. (Also see Pollin, et. al., 2008 for an employment targeting program for Kenya).

Under this framework, the central bank, along with other key government institutions, identified an employment (or, in this case, an "unemployment rate") target. Then, using models and estimates of the South African macro-economy a set of monetary policy instruments can be determined – *along with a number of other policy tools such as credit policy and fiscal policy* – which together can achieve the target unemployment rate, while maintaining a moderate inflation rate and an acceptable level of exchange rate variability. In the particular Vector Auto-Regression Model (VAR) developed by Epstein in Pollin, et. al., a simulation model shows that if the South African Reserve bank lowers the interest rate from 11% to 7% and holds it at that level for 5 years, economic growth will increase on average by .5% per year, inflation will go up by 1 % point and the increase in exchange rate variability will be quite modest. In combination with other policies –discussed below - such as credit guarantees and subsidized credit for labor intensive sectors, as well as capital management techniques and incomes policies if necessary, the unemployment rate can be halved by 2014 as proposed by the South African government.

## 2.9 Diagnostic: VAR modeling of Employment Targeting

One commonly used method to estimate the impacts of macroeconomic policy on macroeconomic variables, such as GDP growth, inflation and exchange rates, is the so-called Vector Auto-Regression or VAR approach. This modeling technique estimates a simple macroeconomic model of the relevant economy, using time series regression techniques. The resulting model can then be simulated to generally estimate the impact of

changes in policy variables, such as a reduction in central bank interest rates on GDP growth, employment, inflation and exchange rate variability (or other relevant variables.) Among the limitations of this approach are that long time series are often needed to develop good estimates of the model. This often means that high frequency data are often needed (quarterly, or monthly) and that big structural changes that might affect the underlying structure of the economy need to be relatively infrequent within the period under estimation. Still, this can be a very useful technique for getting a "ball-park" estimate of the likely impact of employment oriented monetary policy. (See Epstein, 2008, for an example of this approach in the case of South Africa).

## **2.10 Targets, Instruments, Knowledge and Central Bank Culture**

A key consideration is that developed by Nobel Prize winner, Jan Tinbergen. As Tinbergen famously put it, policy makers need as many independent instruments as they have independent targets. Much of what we discuss below concerns the development of additional tools to help the macroeconomic authorities achieve multiple targets.

But the need for learning and innovation by the central bank will be much greater than this for a simple but profound reason: most central banks don't really know very much about how to generate employment. The reasons for this are many, but the most important one is quite simple: for many years now, most central banks didn't have to worry about generating employment, because they were pressured only to be concerned about inflation (or the exchange rate). As a result, central banks (and associated economics researchers the world over), have devoted millions of dollars and countless hours on economic analysis and modeling to figure out the relationship between monetary policy and inflation, while spending virtually nothing on discovering the relationship between monetary policy and employment generation or monetary policy and financial stability. So not only will the central bank have to develop new instruments because they have more targets than instruments, but they will have to develop new instruments because the target is "new" and unfamiliar.

As central banks learn more about how to use monetary policy to increase employment, and as they develop new tools to reach this target subject to an inflation constraint, they might discover that they are *re-inventing* tools that were part of the standard central bank tool kit in the developing world in the 1950s, 60s and 70s, as we discuss further below: credit allocation policies; giving support to development banks; regulations in support of development lending. For the most part, policies such as those that were largely eliminated in the 90's - sometimes for good reason, sometimes not- will be re-discovered, modernized and made better.

## **2.11 Conclusion**

More socially useful central bank frameworks than inflation targeting do exist. These can help put decent employment, poverty reduction and financial stability center stage in macroeconomic policy making. But these must be supplemented by other instruments and supported by other institutions. General fiscal policy is crucial for employment-oriented macroeconomic policy. Other institutions, such as development banks, fiscal policy support of credit allocation mechanisms, capital management techniques, and exchange rate management are all necessary and important supportive policies to which we will now turn.

## 2. Financial Policy and Structure

### 3.1 Introduction

The employment targeting approach to central bank policy described in the previous section might seem quite alien to those schooled in the orthodox tradition of inflation targeting and financial liberalization, in fact, policies like those described above historically have been quite common in both the currently developed and the developing countries (Epstein, 2007). Over the years, central banks have been seen as agents of economic development, not just agents of economic stabilization. And while sometimes central banks have failed quite spectacularly in this mission, there have been other important success stories, including important periods in the U.S., U.K., France, Germany, Japan, South Korea and India, to name just a few examples. In continental Europe, the banking system, often directed by the central bank in conjunction with the ministry of finance, helped to mobilize and direct credit for industrial development. Even in the U.S. and U.K. these policies were used to direct policy to promote social sectors such as housing; in the U.S. and the U.K., central bank policy and regulations were used to promote the financial sector as well.

As for developing countries, Alice Amsden describes the key role that investment banks played in the industrialization success stories such as South Korea, Taiwan, Malaysia, Brazil, Argentina and others, in mobilizing and directing savings to key industrial sectors, and in particular, those specializing in exports. (Amsden, 2001). In many of these cases, central banks were a key part of the government apparatus that played a supporting role by maintaining low interest rates, maintaining capital controls to help stabilize exchange rates at competitive levels, and sometimes engaging in direct lending for preferred purposes.

In some countries, engaging in these developmental roles, using a wide variety of instruments, was seen as a key part of the central bank's mission. After the Second World War, there was a major transformation of central banking in the developing world. In many respects, these changes paralleled those in the developed world just described. But in developing countries, central banks were much more emphatically *agents of economic development* than in many richer countries. (Epstein, 2007a). Hence, we need to re-engage central banks, finance ministries, and the financial system generally in playing a much more active role in generating employment, promoting development, and maintaining financial stability.

This is especially true now that we have seen again the severe dangers of lightly regulated private finance. But even before the most recent disastrous crisis, the promise of financial liberalization for development in poor countries was lacking in supportive evidence.

Still, we must be aware of the failures and excesses of some of these approaches in some countries. As described in Amsden's book, there must be transparent, accountable, and control mechanisms to ensure that these developmentally oriented financial institutions do not contribute to macroeconomic instability, inefficiency or financial or political corruption.

### 3.2 The Performance of Liberalized Financial Systems in Developing Countries<sup>12</sup>

The dominant financial policy in recent years in most developing countries, has focused a financial liberalization. But while financial liberalization has had some successes, for example, financial development in Costa Rica and some other countries, it has also had numerous failures. On the positive side of the balance sheet, liberalization has furthered the integration of developing countries into global markets. This has meant that some large firms, especially in the context of privatization programs, have received significant finance through the internationally-integrated capital markets created or expanded following financial liberalization. The finance provided to these firms has often been cheaper than that available via bank loans.

Still, there is little evidence that the growth of capital markets increases access to or lowers the cost of finance for those entrepreneurs that have long confronted severe capital constraints. Indeed, as McKinley shows, commercial banks have concentrated their activities in major urban areas of developing countries. He goes on to explain that “although aggregate statistics of financial deepening might have improved following financial liberalization, access to credit has become, if anything, more unequal. The rural population remains deprived of credit in most countries, and is likely worse off compared to the access to credit that state-owned agricultural banks had previously provided” (p. 21). McKinley (2005:23) concludes that, in the African case, the private sector has even less access to credit after financial liberalization than before.

Large, foreign-owned banks come to play a greater role in the domestic financial system following the removal of restrictions on their presence. Large, foreign-owned banks that generally enter developing countries after liberalization are often not responsive to the needs of small- and medium-sized enterprises SMEs.

There is a large body of empirical evidence demonstrating that domestic financial liberalization has failed to deliver many of the rewards claimed by its proponents. Financial liberalization has created the climate, opportunity and incentives for investment in speculative activities and a focus on short-term financial gains. In a number of cases, this has “crowded out” long-term developmental returns. Granted, the creation of a speculative bubble may temporarily result in an increase in investment and overall economic activity. But an unsustainable and financially fragile environment or what Grabel (1995) terms “speculation-led development” is unlikely to be in the long-term interest of developing countries. One channel by which the speculation-led development induced by financial liberalization worsens the situation of the poor is through its effect on financial fragility, and ultimately on the prevalence of currency, banking and overall financial crises. Many empirical studies find that financial liberalization, including the liberalization of capital accounts, often leads to currency and banking crises (see Grabel, 2003a,b,c and Reinhart and Rogoff, 2008a and 2008b).

Financial liberalization also can worsen the situation of the poor by increasing income and wealth inequality and by aggravating existing disparities in political and economic power. This is because only a very small proportion of the population is situated to exploit the opportunities for speculative gain available in a liberalized financial environment. Speculation-led development often creates a small class of financiers who maintain greater ties to financial markets abroad than to those in their own country, and it is also associated

<sup>12</sup> See Epstein and Grabel (2006), for a discussion of these issues from which some of this is drawn.



with a shift in political and economic power from non-financial to financial actors (Gabel, 2002).

### 3.3 The Role of the Financial Sector

Hence, to promote more and better employment, poverty reduction and reduce financial instability, other financial policies are required. To achieve these outcomes, financial policies have to serve both general purposes, as well as achieve outcomes quite specific to the needs of particular countries and regions. More specifically, the financial sector can play an important and productive role in promoting employment growth and poverty reduction through the following channels. It can:

- Mobilize savings that can be used for productive investment and employment creation;
- Create credit for employment generation and poverty reduction at modest and stable real interest rates;
- Allocate credit for employment generation and help the poor to build assets, including in agriculture and in small- and medium-sized enterprises and in housing;
- Provide patient (long-term) credit for productivity-enhancing innovation and investment;
- Provide financing for public investment to provide for employment generation and productivity enhancement;
- Help to allocate risks to those who can most easily and efficiently bear those risks;
- Help to stabilize the economy by reducing vulnerability to financial crises, pro-cyclical movements in finance, and by helping to maintain moderate rates of inflation;
- Help the poor by providing basic financial and banking services.
- Increase domestic investments, and thus potential self-reliance

### 3.4 Challenges with Current Financial Structures

There are many challenges because the financial sector in many developing countries are not currently performing these roles to an adequate degree.<sup>13</sup> Despite financial liberalization, and in some cases even because of it, financial structures in many developing countries are not fostering development and poverty reduction. The same can be said of the global financial system. In what follows, we highlight six key problems with current financial structures in the developing world.<sup>14</sup>

#### 3.4.1 Challenge no.1: *Real Interest Rates and Interest Rate Spreads are high*

Real interest rate spreads remain very high in many developing countries, and especially in sub-Saharan Africa. The banking systems are highly concentrated, often foreign dominated, where banks hold high levels of excess reserves and lend primarily to very large businesses and wealthier consumers. (See Heintz, 2008). Table 4 shows some representative interest rate margins between lending rates and deposit rates.<sup>15</sup>

<sup>13</sup> Of course, there are examples of well performing financial sectors in some developing countries. Most of these retain a significant degree of regulation (see Stallings and Studart, 2006), for example, for a good discussion of Latin America.

<sup>14</sup> This section draws on McKinley (2006) and Epstein and Grabel (2006).

<sup>15</sup> Ironically, having large cash reserves may have been a saving grace for some banks and banking systems in the current crisis. A separate research study could assess the costs and benefits of these reserves under different levels of financial stress.

**Table 4 Interest rate margins in selected areas, 2000 - 2005**

	2000	2001	2002	2003	2004	2005	AVG
Madagascar	11.50	13.25	13.25	12.75	10.31	8.25	11.55
Sub-Saharan Africa	13.08	13.72	13.00	12.11	12.85	11.67	12.74
Low-Income	13.08	13.72	13.00	12.44	12.17	11.26	12.61
World	7.35	7.14	7.18	6.97	6.47	6.52	6.94

Source: World Development Indicators (2007b)

### *3.4.2 Challenge no. 2: Credit Creation is too low*

In many poor countries, high spreads and real interest rates are associated with relatively low rates of credit creation.

### *3.4.3 Challenge no. 3: Global Savings are badly misallocated*

While savings rates are too low in some countries, a bigger issue is that savings are badly mis-allocated globally. In recent years a handful of rich countries, most notably the United States, has been running savings short-falls relative to investment, while many other regions of the world have been saving more than they have been investing. As a result, poorer countries have become net lenders of resources to the United States, or have borrowed from the rest of the world much less than they had in earlier periods. Africa on the whole is still a net borrower of funds and its overall savings rate is lower than that of the rest of the world. So mobilizing more savings in Sub-Saharan Africa, in principle, would be an important goal. However, if that savings fails to translate into domestic investment and instead goes overseas, then raising the savings rate there would do little for growth or the poor. In Africa, especially, this problem of capital flight that has been exacerbated by capital account liberalization, is an important one (Boyce and Ndikumana, 2001). Capital management techniques, as we discuss below, can help stem this capital flight.

### *3.4.4 Challenge no. 4: Credit and Capital Flows are Pro-Cyclical*

When capital flows do come into many developing countries, they are often short-term and pro-cyclical, and sometimes associated with "sudden-stops". These can, in turn, lead to financial crises that can have devastating economic impacts, often especially for women and the poor. Ocampo, 2003). Again, capital management techniques as discussed below can help countries manage such disruptive flows.

### *3.4.5 Challenge no. 5: Insufficient Amount of Long-Term, Patient Capital*

The short term and unstable flows of international capital represent a more general, severe problem facing many developing countries -- namely, there is a dearth of long-term, patient capital to support long-term investment (Stallings and Studart, 2006). Much capital is of a highly short term nature, especially in the poorest countries in Africa, Asia and Latin America. As a result, long-term productive investment is extremely difficult and costly to finance.

### *3.4.6 Challenge no. 6: Insufficient Capital for Small and Medium Enterprises and the Poor*

Finally, there is a lack of capital for small and medium enterprises and the poor in most regions of the world (Stallings and Studart, 2006). This problem flows from many of the "stylized facts" described earlier: the high real interest rates and interest rate spreads, the mis-allocation of global financial resources, the short-term and pro-cyclical nature of international capital flows, and the absence of long-term, patient capital. An additional reason is the ability of banks to allocate their assets to high yielding, relatively safe, government securities, which may crowd out lending to SME's and others.

As we have seen, in many countries, the preferred solution to this problem has been a heavy dose of financial liberalization (Nissanke and Aryeetey, 1998; Honohan and Beck, 2007). Recently, liberalization has been combined with the attempt to create a regulatory framework which would monitor and guard against financial instability, while creating space for private financial investment and enterprise, often from abroad. But as the current crisis demonstrates, financial liberalization by itself will not be sufficient to do the job. (Serieux, 2008; Honohan and Beck, 2007; Heintz and Pollin, 2008).

(This paragraph is rather biased against MF: a more balanced take would be better e.g. on interest rates, not always "excessively high" and usually a lot lower than interest rates typically charged by moneylenders; scale has been achieved by some microlenders; and it is a bit misleading to state that such loans do little to help SMEs as most microlending is not designed to do that). Another increasingly popular approach is to build up the microfinance sector. Micro lending can have some very positive impacts: sometimes interest rates are lower than other alternatives facing borrowers such as loans from money lenders; some micro-lenders have been able to achieve scales. Yet, although beneficial for some, the main problems of microfinance are: 1) the interest rates on loans are often excessively high and 2) the scale of loans available is still too often too low to facilitate a significant structural transformation and significant increases in productivity. Such loans often finance consumption loans, or the start of individual home enterprises at a very low scale, but are not designed to help small and medium enterprises (SMEs). Still, to be sure, microcredit has often found innovative solutions to the problem that poor borrowers starting new businesses lack collateral and are therefore not able to receive loans from formal sector financial institutions. A key challenge, then, is to build on the successes of the micro-banking sector, and devise ways to bring these successes – modified as necessary – up to scale.

#### *3.4.7 Challenge no. 7: Insufficient attention to the problems of rural borrowers*

Even though people living in rural areas make up the vast majority of the world's poor, rural residents are the most underserved in terms of financial services. A number of the solutions presented below should be designed specifically with the rural poor in mind.

### **3.5 Some Financial Solutions**

One important approach, then, is to combine the resources available to formal sector financial enterprises and government financial institutions such as the central bank with the access, innovation, and lending experiences of microcredit institutions (Heintz, 2008; Atieno, 2001; Aryeetey, 2001; Pollin, Githinji, and Heintz, 2008). There are several ways to do this that have been suggested in the literature, and also put into practice, if only on a small-scale basis. Among the most promising are those that involve programs in which formal sector institutions such as commercial banks or central banks take positions in cooperative, microcredit and other development-oriented financial institutions, either by lending to them and or by taking equity positions in them. To be successful, these programs usually involve government regulations and subsidies that generate carrots and sticks for formal sector institutions to extend credit to these smaller institutions that then on-lend to poor and/or small borrowers with good potential.

Another way to raise lending and investment to scale so that it can have a transformative impact is to create *development banking institutions* that take direct positions in final borrowers who are engaged in activities that will generate large numbers of good jobs and high value-added, and contribute to the structural transformation of the economy. The government of Madagascar is considering this approach, as we discuss in more detail below.

Mobilizing financial resources and allocating them to productive units in key sectors could be a crucial component of the development strategy for developing countries.

Building on work we have undertaken in Ghana, South Africa, Kenya and Madagascar, we suggest financial policies and innovations that could be implemented, such as asset-backed reserve requirements, development banking, and loan guarantees, that can help generate more investment in key sectors to increase employment and incomes for the poor (Pollin, Epstein, Heintz, and Ndikumana, 2006; Epstein and Heintz, 2006; Pollin, Githinji, and Heintz, 2008; Epstein and Grabel, 2006).

Here we outline several policies along these lines that can be used to help re-deploy and transform the financial sector to facilitate the MAP and help achieve more good jobs, raise productivity, and reduce poverty in Madagascar.<sup>16</sup> In particular we will focus on three: 1) Asset backed reserve requirement (ABRR); 2) loan guarantees; and 3) development banking.

### **3.6 Formal Sector Banks**

Carrots and sticks need to be applied to formal sector banks to get them to lend more to high-priority sectors, or that can be identified by the type of input-output analysis we described above. Here we present two examples of carrots and sticks that can be used to encourage formal sector banks to become so engaged. The first is asset-backed reserve requirements (ABRR); the second, more extended example, is loan guarantees.

#### **3.6.1 Example I: Asset-backed reserve requirements (ABRR)**

As discussed in more detail in Pollin et al. (2006, 2008), with a system of asset-backed reserve requirements (ABRR), banks are required to hold reserves against their income-earning assets. However, they are allowed to hold smaller required reserves on assets that are identified as contributing to employment generation and poverty reduction, perhaps using the type of analysis we describe below. This would encourage banks to lend directly to high-priority sectors. Similarly, securities issued by smaller institutions that are experienced in making loans to small/poor borrowers or small and medium sized enterprises, microfinance institutions (MFIs), and rural banking cooperatives can have preferred reserve requirements as well.

#### **3.6.2 Example II: Loan guarantees – Loan guarantee scheme<sup>17</sup>**

<sup>16</sup> This section draws heavily on Epstein and Heintz (2006); Epstein (2007); Heintz and Pollin (2008); Pollin et al. (2006, 2008).

<sup>17</sup> This section draws extensively on Pollin et al. (2008), especially chapter 9. Also see Atieno (2001), who discusses such a program for Kenya.

A loan guarantee program could help to mobilize resources from commercial banks for on-lending to microcredit and other institutions who have the knowledge and experience to on-lend to cooperatives, small entrepreneurs, and businesses for productive activity, or to make direct loans to the final borrowers, if the commercial banks so choose. The basic idea is that the government would guarantee a certain percentage of the loan, thereby reducing the default risk faced by the bank; this can help to substitute for collateral which most borrowers in the target group will not be able to provide. This would also help keep the interest rate charged to the final borrowers lower.

There has been extensive experience with loan guarantee schemes spanning many countries over many years. Green (2003) estimates that there have been over 2000 loan guarantee programs of various kinds in almost 100 countries, including most OECD countries as well as in many developing countries. Evidence on their success is mixed, as one would expect with some many schemes in so many places. (Green, 2003; Beck, et. al., 2008; Honohan, 2008). In the United States and Canada, major loan guarantee schemes for small business are seen as quite successful. (Green, 2003, p. 22.) Many programs established in Latin America in the 1980's and in some parts of Africa then a bit later, however, are commonly seen as having failed. (Green, p. 23.) Still, according to a UNIDO sponsored study, the best developed African schemes are in Egypt, Morocco and South Africa. (Green, p. 23).

While there are many types of loan guarantee programs, we discuss one such type here (see Honohan, 2008, Beck., et. al, 2008 and Green 2003 for a discussion of other types of programs.) Our suggested program works as follows. The government chooses to guarantee a certain portion of loans from commercial banks or other lenders to borrowers who will achieve program goals, such as generate more decent jobs, increase productivity, and improve the quality of jobs, or invest in innovations or infrastructure to reduce the cost of inputs or consumption goods consumed by the poor, and thereby have strong multiplier effects through the economy to raise the standard of living of the poor. The guarantees may also underwrite a program by commercial banks to lend to microcredit institutions who will then lend to final borrowers.

In setting up such a program, there are several issues that must be addressed:

1. How to determine to whom to lend
2. What should be the rate of loan guarantee?
3. How to monitor the program to avoid corruption, excessive moral hazard, and inefficiency

### 3.6.3 *How to determine to whom to lend*

*Indirect lending to development institutions.* The key here is to start with development finance institutions that have the knowledge, track record, and experience to identify final borrowers that can use the credit productively to create decent jobs, directly or indirectly, for themselves and, on a larger scale, for others in their community. The point is to raise the scale and reach of these institutions. Careful attention needs to be paid to the organizational structure of the program, and it may vary from region to region. But the key is to pool the resources to be able to benefit from economies of scale and knowledge, without so much centralization that the programs bypass small borrowers that can both benefit directly and have the possibility to help create value for their locales and communities.

*Direct lending by commercial banks.* If the large banks want to start lending directly to such borrowers, then, since they do not have a track record of doing so, it would work best if they were to develop a business plan and a “Decent Employment Impact Statement” that makes clear how many jobs, and at what wages and benefits, would be generated by their loans, and, if possible, some clear idea of the domestic linkages and multiplier effects. Such direct lending, especially to small and medium enterprises, could be highly desirable, but to receive the loan guarantees, they would have to demonstrate the likely employment

effects. As we will see below, a number of monitoring and enforcement mechanisms will be useful to ensure that these employment impacts are actually forthcoming.

### *3.6.4 What should be the rate of loan guarantee?*

In choosing the rate of loan guarantee, there are a number of considerations that must be taken into account, including moral hazard, and the cost of the program to the government. The problem of moral hazard dictates that the government guarantee must be less than 100% of the loan, and possibly significantly less. To reduce moral hazard (and the cost to the government), other mechanisms that substitute for collateral should also be developed, as we describe below. As we see momentarily, the cost to the government will also depend on the rate of guarantee. The higher the rate of guarantee, all else constant, the higher the cost to the government and the greater the problem of moral hazard. However, the lower the rate of government guarantee, the less attractive will be the program to lenders and to borrowers.

### *3.6.5 How much would this program cost the government?*

Setting aside administrative costs, the major cost to which the government would be exposed is the cost of defaults. How large a cost would this be to the government? This depends on the size of the program and the default rate. Let's start first with the size of the program. Take the case of Madagascar, for example. According to the Madagascar Action Plan (MAP), the government wants to raise the rate of gross domestic investment from 22.5% of GDP in 2005 to 30% of GDP by 2012 (MAP, Commitment 6). To help achieve this goal, let's say the government implements a loan guarantee program equal to 5% of GDP (a little more than 20% of investment in 2005) in the hope that this would substantially raise the rate of investment according to the MAP's goal.

Now turn to the rate of default. Take the example of Madagascar again. According to the latest figures compiled by the Madagascar banking commission, the rate of non-performing loans on the commercial banks was 9% in 2007 and, at the height of the recent political instability, it was 19.6%. Let's say that the rate of default was much higher than that, say 30%. What would the cost of the program be? In this case, the cost would be  $.3 \times .05 = 1.5\%$  of GDP. The budget deficit in 2007 was about 500 billion Ariary, or 3.6% of GDP.

If the default rate was 20% instead of 30%, which is probably a more realistic figure, then the cost would be 1% of GDP, thereby raising the budget deficit by significantly less than one third.

The program could be made cheaper of course by reducing the guarantee rate. Hence there is a tradeoff between the rate of guarantee (and, therefore, the cost to the government) and the cost to the borrower, all else being equal.

What other changes could reduce the severity of this tradeoff? There are several:

1. Reduce the rate of default: If the rate of default was lower, then the cost to the government would be lower for any rate of guarantee. Having a good system of monitoring, and good programs of selecting and working with borrowers, is crucial to reducing the default rate. We discuss this below in terms of anti-corruption measures. There other important measures learned from micro-credit and other lending, including educational programs and mutual monitoring, (in the next section????...this seems too limited as it focuses on monitoring as an anti-corruption tool but there is more to "selecting and working with borrowers to reduce the default rate" than that).
2. Reduce the base rate. There are several ways of reducing the base rate:

- Less tight monetary policy can lower the base rate, for any given inflation rate.
- More competition in the banking system can lower the rate, which is quite high by international standards.
- More competitive and better organized auctions of government debt can lower the base rate.

### 3.6.7 *Monitoring and anti-corruption protection*

As discussed in detail in Pollin, Githinji, and Heintz (2008), a potential problem with any program is corruption. In business as well as government, monitoring and accountability issues will be crucial. In the case of the loan guarantee program, it is quite easy to see the form that corruption could take, especially where the government guarantees a large percentage of the loan: the lender and borrower could arrange a false loan; the borrower could default, receive the payment from the government, and split the proceeds.

Of course, close monitoring and accounting could, in principle, prevent such corruption from occurring. But monitoring itself has costs and there are advantages to add complimentary measures to monitoring schemes to reduce the incentives for corruption. Pollin et al. (2006, 2008) have designed an anti-corruption system based on escrow accounts and “whistleblower” awards that can help cut down on the likelihood of significant corruption. These are described briefly in the following paragraph.

### 3.6.8 *Incentive-based monitoring*

*Escrow accounts.* To reduce the incentive for corruption, the government could implement a system of escrow accounts. The account would work as follows: the lender places a percentage of the loan in an escrow account with the government or central bank. If there is a default, the lender will receive the amount placed in escrow only after a thorough investigation of the case to establish there was no corruption involved. If there is no default, then the borrower receives the amount at the end of the period, which can then be rolled over as part of the new loan with minimal administrative interventions (forms, filings, etc.) or can be repaid to the lender. Such escrow accounts clearly cut down on incentives for corruption, but this is at some cost in terms of the availability of funds to the borrower.

*Whistleblower incentives.* This is another incentive-based monitoring measure suggested by Pollin et al. (2007), based on an idea promoted by Dean Baker. His idea is to create large penalties for fraud, combined with high rewards for “whistleblowers” (combined with strong penalties for fraud on their part). For example, defrauding the loan guarantee system would involve large civil and possibly even criminal penalties. Bank employees or others with key information used to prove or to lead to investigations that would prove fraud, receive a sizeable financial reward.

Corruption and inefficiency can plague all economic endeavors, be they private or public. Having sensible, serious policies in place to reduce the incentives for corruption and to identify and penalize can make a key difference between a successful and an unsuccessful program.

One objection to these types of mechanisms is that they might seem to be similar to the “directed lending programs” that have failed in earlier periods. However, the programs described above are designed to incorporate strong monitoring and anti-corruption mechanisms and are also part of development programs that are embedded in large-scale market-based initiatives.

### 3.6.9 *How to pay for the loan guarantee program*

Loan guarantees can be attractive, at least on a start-up basis, to foreign aid donors. But donors aside, a key source of funds could be a dedicated tax which underwrites this set of financial incentives for economic transformation. Of course there will be many worthy demands on tax revenues. We argue here that among the demands that should be considered, is a loan guarantee program to help generate investments in good jobs for the long term.

### *3.6.10 Development banking initiatives*

Development banking initiatives were crucial in the successful development of industrial economies of Asia and Latin America, what Alice Amsden calls “The Rise of the Rest” (Amsden, 2001), but the reputation of “development banking” experiences in Africa has been seriously tarnished. Yet the major challenges for development and financial policies – and the insufficiency of financial liberalization as a solution - call for a re-consideration of numerous policy options, including the revival of development banking (Ndikumana, 2007). Success of development banking initiatives in Africa depends on: integration of development finance institutions into the national development agenda; appropriate governance; efficient operating procedures; minimizing non-interest barriers to access to credit; and innovative strategies for the mobilization of stable long-term funds (Ndikumana, 2007, p. 32).

Integration of finance institutions means that the design of the national development plan should specifically take into account the role of these institutions. This could include the mandating that development banking institutions focus on specific sectors; the government developing a monitoring system to evaluate the performance of the development banks; and a system of incentives to award good performance and to penalize poor performance. (Ndikumana, 2007).

## **3.7 Central Bank Support for Development Banking and Small-Scale Financial Institutions**

As discussed in Epstein (2007a), central banks have historically played a much larger role in supporting longer-term economic development goals than has become fashionable more recently. This has been true both in developing countries and in the now developed countries. Central banks, acting as agents of development, have bought long-term bonds for infrastructure development; kept and administered differential interest rate ceilings in support of favored sectors, such as housing in many developed countries (Epstein, 2007a); used their discount window to discount loans for specialized lending institutions, such as microcredit institutions in Asia (Asian Development Bank, 2000); and provided efficient or even subsidized financial services for specialized institutions playing important social roles. These policies have not always been successful, but if planned carefully with monitoring and safeguards, have an important part to play in mobilizing and re-deploying finance for development purposes. For example, central bank support for the Grameen Bank in Bangladesh and for rural development banks in Indonesia have been very successful (Asian Development Bank, 2000) in terms of offering loans to rural inhabitants and providing financial services. In what sense? In terms of jobs created, outreach???. Another role that central banks have successfully played is the management of funds from the central government, and on-lending to MFIs and other institutions engaging in rural and small business lending (Ndikumana, 2007; Asian Development Bank, 2000).

In addition, central banks can play an important promotional role in undertaking studies relevant to developmental finance, and providing data and technical support to institutions undertaking more active financial roles and training (Asian Development Bank, 2000). In countries that have successfully developed rapidly, central banks have taken an active role in mobilizing and channeling resources for developmental purposes (Epstein, 2007a).



### 3.8 Diagnostic II: Using Input-Output Models with Credit Allocation Data to Help Allocate Credit

One big question that arises from this approach is the following: how does one figure out what sectors should be promoted in the hopes that they will generate more employment and poverty reduction? This question must be approached at several different levels. At a general level, there are broad diagnostic tools, such as the one briefly described in this section, that can be applied to identify promising sectors. **But as we will see, this tool can only give a broad indication. To implement a strategy of credit promotion as we have described, there is no substitute for having institutions – public and private – with intimate knowledge of the local economy and context and with the incentives and management to make detailed decisions. As we have described above, there are mechanisms to mobilize and re-direct banks and other institutions to carry out this knowledge acquisition and investments.**

Still, the diagnostic tool described below can be a very useful planning tool at a broad level. Using readily available data, sectors likely to generate directly and indirectly, a significant number of jobs can be determined. The next step is to design programs so that the financial sector will support these sectors. We present below some data from Madagascar, similar work in South Africa and Kenya has also been done.

### 3.9 A Sectoral Analysis of Finance and Employment

The input-output diagnostic tool in the case of Madagascar is described here (see Epstein, et. al., 2008). Table 5, based on the Madagascar enterprise survey, shows the extent to which various sectors had their credit needs met.

**Table 5 Large enterprises in key sectors have easiest access to credit in Madagascar**

Branch and Type of Enterprise	Satisfied (%)
Extractive activities	100.0
Manufacturing	27.8
Production and distribution of energy	100.0
Construction	43.6
Trade	28.6
Hotels and restaurants.	34.2
Transport and communications	63.4
Real estate and other services	16.3
Microenterprises	30.3
SMEs	46.7
Large enterprises	51.0

Source: Madagascar Enterprise Survey (2005)

To what extent are these sectors creating jobs and wages for the economy? To understand how to answer this question, we need to take a short detour to explain the construction of the input-output diagnostic tool.

### 3.10 The Input-Output Model

To understand the dynamics of output, employment, and value-added in a country, we constructed a standard input-output (I-O) model for Madagascar, which also incorporated employment data from the 2001 household survey (*Enquête Auprès des Ménages*), the most recent data available. Specifically, we quantify the relative impact of economic stimuli to particular sectors (e.g., clothing or tourism) or to specific categories of aggregate expenditures (e.g., exports, household consumption, or investment). In addition, we

examine the industrial structure of the Malagasy economy, particularly with regard to the density of upstream and downstream linkages.

In Madagascar, wage employment accounts for a relatively small fraction of total employment. Various forms of self-employment, particularly agricultural self-employment, account for the majority of employment. Therefore, typical employment multipliers – which are often predicated on the assumption of wage employment – do not fully assess the overall employment impact of different economic policies and stimuli. In the case of self-employment, the impact will likely take the form of increasing earnings (i.e. value-added) instead of increasing the number of “jobs.” Of course, changes in the relative earnings of different types of employment may result, over time, in differential entry into and exit from specific economic activities. This could ultimately alter the composition of self-employment. We do not focus on the long-run effects of labor migration and mobility in our analysis. Instead we focus on short-run changes to labor market outcomes. In the case of the self-employed, for the type of analysis pursued here, assumes that the direct impact of a sectoral or aggregate economic stimulus will manifest itself in terms of increases in value-added and earnings.

For wage employment, we calculate typical employment multipliers using the I-O model. We estimate wage employment/output ratios for the various sectors. We were concerned that a total count of employment in waged positions could overstate the employment impact of a given change in output, since underemployed individuals would be weighted the same as a full-time employee. We also wanted to take into account the fact that individuals frequently are engaged in more than one type of employment. Therefore, we converted all wage employment in primary and secondary activities into “full-time equivalents.”

The output multipliers show the impact of a 1 million Ariary increase in the final demand for output of the industry in question on total economic output in Madagascar. The value-added multipliers can be interpreted in a parallel manner. They indicate the impact on value-added, not industrial output. Value-added is equal to the value of industrial output less the value of intermediate inputs used in production. Therefore, the value-added multiplier must be less than the output multiplier. The difference between the output multiplier and the value-added multiplier reflects direct and indirect changes in the demand for domestically produced intermediate inputs associated with a change in final demand. The value-added multiplier is a better indicator of the impact of expanding the sector on incomes in Madagascar than is the output multiplier. Also of interest are the wage employment multipliers. These indicate the total number of jobs (measured as full-time equivalents, as discussed above) across all sectors that would be generated by a 1 million Ariary increase in the final demand for the output of the specific sector in question.

One of the reasons for the variations in the size of the multipliers, particularly the output multipliers, is that different industrial sectors have different linkages to the domestic economy. Some sectors have a large number of “upstream” linkages to other activities – meaning that they utilize a large amount of domestically produced inputs in their production processes. Others have “downstream” linkages – their outputs are used by other domestic firms to produce final goods and services. Industries may have weak multipliers when they import the inputs used in production. This is one of the principal leakages that occurs in a standard I-O model. In our model, which incorporates endogenous household consumption, we note that leakages can also occur when households buy imported goods instead of domestically produced ones.

We can construct general indicators of the extent of upstream and downstream linkages in the Malagasy economy. The density of upstream linkages is estimated by calculating the value of domestically sourced inputs as a percent of the value of total non-labor inputs into production (calculated at market prices). The density of downstream linkages is estimated by the amount of domestic industrial demand expressed as a percent

of total domestic output for each sector. In addition, we calculate an indicator of the intensity of use of imported inputs – the value of imported inputs expressed as a percent of total non-labor production costs.

**Table 6 Consolidated industry multipliers in Madagascar**

	Multipliers		Employment (per million Ariary)		Upstream Linkages
	Output (per million Ariary)	Value-Added (per million Ariary)	Wage	Non-Ag.	Domestically Sourced Inputs as % of Non-labor Production Costs
Agriculture	3.4	2.0	292	157	65%
Extractive industries	3.5	1.8	384	340	71%
Manufacturing	3.3	1.5	264	203	65%
Energy	2.3	0.7	311	295	36%
Construction	3.0	1.4	208	174	53%
Commerce/trade	3.5	2.0	278	227	75%
Hotels and restaurants	3.5	1.3	289	236	72%
Transport and communications	3.5	1.7	342	299	76%
Real estate and business services	3.9	1.9	507	458	89%

Source: Derived from input-output tables (2001) (see Epstein, et. al. 2008)

Using these multipliers, we can see that in Madagascar, credit is apparently not currently directed to the sectors that would generate the most jobs, either directly or indirectly.<sup>18</sup>

**Table 7 Credit is not allocated to sectors with highest multipliers or upstream linkages**

Sector	% of Credit Needs Satisfied	Value-Added Multiplier	Upstream Linkages
Commerce/trade	26.6	2.0	75%
Agriculture	NA	2.0	65%
Real estate/Business services	16.3	1.9	89%
Extractive industry	100	1.8	71%
Transpiration/Communications	63.4	1.7	76%
Manufacturing	27.8	1.5	65%
Construction	43.6	1.4	53%
Hotels/Restaurants	34.2	1.3	72%
Energy	100	.7	36%

Source: Authors' input-output analysis.

<sup>18</sup> The term "directly" refers to the employment generated within the particular sector; by "indirectly" we mean the employment generated in the sectors that sell inputs to the sector at issue.

### 3.11 Conclusion

The financial sector, which in many countries have has failed to play an important role in development, must be mobilized to help promote development, poverty reduction and decent employment. This section suggested some concrete approaches, policy tools, and diagnostics to help carry out these mobilization. Of course, these are very general approaches and they must be fine tuned and made specific to the country contexts when actually applied.

With globalization and the increased integration of economies – with all their attendant opportunities and risks – employment oriented macroeconomic policy must also cope with the crucial international macroeconomic dimensions to succeed. Among the many international issues that bear on this problem, we deal next with just two: exchange rate management and management of capital flows. These are both intimately related to the issues of financial stability and employment oriented macroeconomic policy.

## 4. Exchange Rates and Capital Management

### 4.1 Introduction

International financial markets have become treacherous for developing countries. Even in the best of circumstances, developing countries, by virtue of their size and location in the global economy, cannot help but be buffeted by major swings in the markets. Still, developing countries can undertake policies to protect themselves from the exigencies of global prices, commodity and financial flows. And in calmer times, these countries need tools to best manage their macroeconomic needs within a global context, especially if they want to achieve better outcomes for decent employment, poverty reduction and financial stability. We have seen that an employment oriented monetary and financial policy framework needs to be able to have a stable and competitive real exchange rate, the ability to mobilize and allocate credit to desired sectors, reasonable real interest rates and inflation rates, and financial stability.

Managing the real exchange rate and international debt and capital flows is crucial to achieving these outcomes. These are difficult even under the best of circumstances, and become extremely difficult to achieve in a context of wide-spread financial liberalization, as unstable and pro-cyclical inflows of capital can lead to inappropriate real exchange rates. Also, when capital suddenly stops coming in and then leaves ("sudden-stops") it can leave a trail of debts and problems that are difficult to cope with. Hence, *capital management techniques*, widely used by successful countries such as China, India, South Korea, Taiwan, Singapore and others, need to be employed to deal with these swings in capital and debt flows, as well as for managing the real exchange rate.

Capital management techniques have been used by a variety of countries to supplement the macroeconomic policy *tool-box*, in light of our earlier discussion of targets and instruments available to central banks and financial authorities in general. As discussed,, central banks need more tools if they are to achieve a larger number of objectives. Capital management techniques are among the most important tools that can use to help deal with the exigencies of the international financial markets.

## 4.2 Capital Management Techniques<sup>19</sup>

*Capital management techniques*, refers to two complementary (and often overlapping) types of financial policies: policies that govern international private capital flows and those that enforce prudential management of domestic financial institutions. Regimes of capital management take diverse forms and are multi-faceted. Capital management techniques can be static or dynamic. Static management techniques are those that authorities do not modify in response to changes in circumstances. Capital management techniques can also be dynamic in that they can be activated or adjusted as circumstances warrant. Three types of circumstances trigger implementation of management techniques or lead authorities to strengthen or adjust existing regulations--changes in the economic environment, the identification of vulnerabilities, and the attempt to close loopholes in existing measures.

Some types of capital management techniques have a proven track record, not just in the decades that followed WWII, but in the current environment as well. This latter fact is increasingly recognized today, even by many prominent economists and the IMF (eg., Prasad et al., 2003) who have recently written rather positively (2008)—though nevertheless cautiously—about the role of certain types of market-based, temporary capital management techniques. The problems associated with unfettered international private capital flows have become quite obvious, particularly in light of the current financial crises. Capital management techniques played critically important roles during the high-growth eras of Japan and South Korea and were successfully employed in Brazil in the 1950s and 60s. (e.g., Nembhard, 1996). Chile and Colombia successfully used capital management techniques during the 1990s. The Malaysian government successfully employed stringent capital management policies in 1994 and 1998. India, Singapore, China, and Taiwan POC employed diverse strategies that could be termed (even if not by the government itself) capital management techniques during the 1990s.

Epstein, Grabel and Jomo (2003) presented seven case studies of the diverse capital management techniques employed in Chile, Colombia, Taiwan Province of China, India, China, Singapore and Malaysia during the 1990s. The cases reveal that policymakers were able to use capital management techniques to achieve critical macroeconomic objectives. These included the prevention of maturity and locational mismatch<sup>20</sup>; attraction of favored forms of foreign investment; reduction in overall financial fragility, currency risk, and speculative pressures in the economy; insulation from the contagion effects of financial crises; and enhancement of the autonomy of economic and social policy, including employment generation. The paper examines the structural factors that contributed to these achievements, and also weighs the costs associated with these measures against their macroeconomic benefits. (See Grabel, 2003)

**The general policy lessons** of these seven experiences are as follows.

<sup>19</sup> This section draws extensively on Epstein, Grabel and Jomo (2003) and Epstein and Grabel (2006), and the papers by Grabel in the reference section.

<sup>20</sup> Maturity mismatch occurs when borrowers finance long-term obligations with short-term credit, leaving them vulnerable to changes in the supply and cost of credit. Locational mismatch occurs when borrowers contract debts that are repayable in foreign currency, leaving them vulnerable to currency depreciation that increases the cost of debt service.

1. Capital management techniques can enhance overall financial and currency stability, buttress the autonomy of macro and micro-economic policy, and bias investment toward the long-term.
2. The efficacy of capital management techniques is highest in the presence of strong macroeconomic fundamentals, though management techniques can also improve fundamentals.
3. The nimble, dynamic application of capital management techniques is an important component of policy success. 4.) Controls over international capital flows and prudential domestic financial regulation often function as complementary policy tools, and these tools can be useful to policymakers over the long run. 5.) State and administrative capacity play important roles in the success of capital management techniques. 6.) Evidence suggests that the macroeconomic benefits of capital management techniques probably outweigh their microeconomic costs. 7.) Capital management techniques work best when they are coherent and consistent with a national development vision. 8.) There is no single type of capital management technique that works best for all developing countries. Indeed our cases, demonstrate a rather large array of effective techniques.

Tables 8 and 9 summarize many of the key aspects and impacts of the capital management techniques employed by a range of developing countries during the 1990s (from Epstein, Grabel and Jomo, 2003). These tables complement the discussion below by giving quite specific and concrete country experiences to illustrate the general points about capital management techniques in the discussion that follows.

**Table 8 Experiences with Capital Management Techniques in the 1990's\***

<b>Country</b>	<b>Types of Capital Management Techniques</b>	<b>Objectives of Capital Management Techniques</b>
Chile	Inflows Inflow management FDI and PI: One year Residence Requirement 30% URR <i>Borrowing Restrictions:</i> Tax on foreign loans: 1.2% per year Outflows: No Restrictions Domestic financial Regulations: strong regulatory measures	-Lengthen maturity structures and stabilize inflows  -help manage exchange rates to maintain export competitiveness  -protect economy from financial instability
Colombia	Similar to Chile	Similar to Chile
Taiwan	Inflows <i>non-residents</i> -bank accounts can only be used for domestic spending, not financial speculation -foreign participation in stock market regulated -FDI tightly regulated <i>residents</i> regulation of foreign borrowing Outflows Exchange controls Domestic Financial Regulations -restrictions on lending for real estate and other speculative purposes	-Promote industrialization  -Help manage exchange for export competitiveness  -Maintain financial stability and insulate from foreign financial crises
Singapore	"Non-Internationalization" of Singapore \$ inflows outflows <i>non-residents</i> -financial institutions can't extend S\$ credit to non-residents if they are likely to use for speculation -non-residents: if they borrow for use abroad, must swap first into foreign currency Domestic Financial Regulations -restrictions on creation of swaps, and other	-to prevent speculation against Singapore \$  -to support "soft peg" of S\$  -to help maintain export competitiveness -to help insulate Singapore from foreign financial crises

	derivatives that could be used for speculation against S\$	
Malaysia	Inflows -restrictions on foreign borrowing Outflows non-residents -12 month repatriation waiting period -graduated exit levies inversely proportional to length of stay <i>residents</i> exchange controls domestic financial regulations <i>non-residents</i> -restrict access to ringit <i>residents</i> encourage to borrow domestically and invest	-to maintain political and economic sovereignty  - kill the offshore ringit market  -shut down offshore share market  -to help reflate the economy  -to help create financial stability and insulate the economy from contagion
India	Inflows <i>non-residents</i> Strict Regulation of FDI and PI Outflows <i>non-residents</i> -none <i>residents</i> exchange controls Domestic Financial Regulations -strict limitations on development of domestic financial markets	-support industrial policy  -pursue capital account liberalization in an incremental and controlled fashion  -insulate domestic economy from financial contagion  -preserve domestic savings and forex reserves  -help stabilize exchange rate
China	Inflows <i>non-residents</i> -strict regulation on sectoral FDI investment -regulation of equity investments: segmented stock market Outflows <i>non-residents</i> -no restrictions on repatriation of funds -strict limitations on borrowing Chinese Renminbi for speculative purposes <i>residents</i> exchange controls Domestic Financial Regulations -strict limitations on <i>residents</i> and <i>non-residents</i>	-support industrial policy  -pursue capital account liberalization in incremental and controlled fashion  -insulate domestic economy from financial contagion  -increase political sovereignty  -preserve domestic savings and foreign exchange reserves  -help keep exchange rates at competitive levels

Sources: Epstein, Grabel and Jomo, 2004.

\*This description applies to the experience during the 1990's and not necessarily in the current period.

**Table 9 Effects of Capital Management Techniques in Seven Cases**

Country	Achievements	Supporting Factors	Costs
Chile	-Altered composition and maturity of inflows -reduced vulnerability to contagion	-well designed policies -offered foreign investors good returns -state capacity -flexible application	-higher cost of capital for small firms
Colombia	-similar to Chile but less successful	-less state capacity than Chile -less flexible	
Taiwan POC	-kept debt load manageable -help to keep competitive exchange rate -insulated from financial crises -helped to maintain economic sovereignty		
Singapore	-insulated from disruptive speculation	-strong state capacity -strong economic	-possibly contributed to a less developed financial sector

	-helped manage soft peg -contribute to financial strength	fundamentals	
Malaysia	-facilitated macroeconomic reflation -helped to maintain domestic economic sovereignty	-public support for policies	-possible cronyism/corruption
India	-facilitated incremental liberalization -insulated from financial contagion - helped preserve domestic saving -helped to maintain economic sovereignty	-strong state and bureaucratic capacity -strong public support	-restricted the development of the domestic financial sector
China	-facilitated industrial policy - insulated economy from financial contagion -helped to preserve savings -helped to manage exchange rate and facilitate export led growth -helped to maintain expansionary macro-policy -helped to maintain economic sovereignty	-strong state and bureaucratic capacity -strong economic fundamentals	-constrained the development of the financial sector -facilitated corruption

Source: Epstein, Grabel and Jomo, 2004.

### 4.3 Managing Real Exchange Rates

Exchange market intervention, supported by capital management techniques can be helpful, and indeed might be essential to help maintain a stable and competitive real exchange rate as we discussed earlier. China, Korea, Taiwan, India and many other countries have used capital management techniques as an additional tool to support employment and growth policies undertaken by governments, including by the central bank.

Examples include, Galindo and Ros (2008), as part of Epstein/Yeldan's project on alternatives to inflation targeting in Mexico. Galindo and Ros found that monetary policy was asymmetric with respect to exchange rate movements –tightening when exchange rates depreciated, but not loosening when exchange rates appreciated. This lent a bias in favor of an over-valued exchange rate in Mexico. They propose a ‘neutral’ monetary policy so that the central bank of Mexico responds symmetrically to exchange rate movements and thereby avoids bias toward over-valuation without fundamentally changing the inflation targeting framework. In their own words, ‘the central bank would promote a competitive exchange rate by establishing a sliding floor to the exchange rate in order to prevent excessive appreciation (an ‘asymmetric band’...). This would imply intervening in the foreign exchange market at times when the exchange rate hits the floor (i.e., an appreciated exchange rate) but allows the exchange rate to float freely otherwise.’ They point out that such a floor would work against excessive capital inflows by speculators because they would know that central bank will intervene to stop excessive appreciation. If need be, Galindo and Ros also proposed temporary capital controls (as do others from the PERI/Bilkent project) as a way of maintaining a stable and competitive real exchange rate.



#### 4.4 Policies toward Foreign Borrowing to Help Maintain Financial Stability<sup>21</sup>

In the current crisis, excessive foreign borrowing has made some countries especially vulnerable to "sudden stops" in the flows of financial resources.

One way of dealing with such problems is for developing countries to consider drastically reducing their reliance on foreign bank loans. For example, policymakers could enforce strict ceilings on the volume of new foreign loans that can be incurred. Such ceilings might involve strict limits on the allowable ratio of foreign to total loans, or might require that firms finance only a certain percentage of their projects with foreign loans that have a certain maturity and/or locational profile.

Once the worst of the current crisis is over and a significant amount of capital flows resume, restrictions on foreign borrowing could be deployed dynamically as circumstances warrant, following the trip wire-speed bump approach. Under this approach, policymakers monitor a trip wire that measures the economy's vulnerability to the cessation of foreign lending. This involves calculating the ratio of the government's holdings of currency reserves to private and public foreign-currency denominated debt (with short-term obligations receiving a greater weight in the calculation). If this ratio approached an announced threshold, policymakers would then activate a graduated speed bump that precluded new inflows of foreign loans until circumstances improved.

Policy can also discourage--rather than prohibit--the use of foreign loans as a source of finance. Tax systems can be used in a number of ways to discourage domestic borrowers from incurring foreign debt obligations. Domestic borrowers could pay a fee to the government or the central bank equal to a certain percentage of any foreign loan undertaken. This surcharge might vary based on the structure of the loan, such that loans that involve a locational or maturity mismatch incur a higher surcharge. Alternatively, the surcharge might vary based on the level of indebtedness of the particular borrower involved, such that borrowers who already hold large foreign debt obligations face higher surcharges than do less-indebted borrowers. This tax-based approach could encourage borrowers to use domestic sources of finance since these would not carry any surcharge. Another strategy could involve varying the surcharge according to the type of activity being financed by foreign loans. For instance, borrowers could be eligible for a partial rebate on foreign loan surcharges when loans are used to finance types of production that are highly employment intensive.

To the extent that borrowers assume at least some foreign loan obligations, it is imperative that the allocation and terms of these loans be managed by the government. Careful management of the allocation of foreign debt can ensure that it is used for productive, developmental purposes. Prior to financial liberalization in the 1990s, many governments in East and Southeast Asia tightly coordinated allocation and access to foreign loans. Until quite recently, policymakers in China and India maintained tight restrictions on foreign borrowing through a variety of means.

In general, authorities should avoid widespread *maturity* and *locational* mismatches. A Maturity mismatch occurs when borrowers finance long-term obligations with short-term credit, leaving them vulnerable to changes in the supply and cost of credit. A locational mismatch occurs when borrowers contract debts

<sup>21</sup> This section draws heavily on Epstein and Grabel (2006), and Grabel (2003c).

that are repayable in foreign currency, leaving them vulnerable to currency depreciation that increases the cost of debt service.

In addition to the ceilings, surcharges or approval processes discussed above, policymakers can design trip wires and speed bumps that are designed to keep the levels of maturity and/or locational mismatch below the critical thresholds. A trip wire for locational mismatch is the ratio of foreign-currency denominated debt to domestic-currency denominated debt (with short-term obligations receiving a greater weight in the calculation). A trip wire for maturity mismatch is the ratio of short-term debt to long-term debt (with foreign-currency-denominated obligations receiving a greater weight in the calculation). A graduated series of speed bumps that require borrowers to reduce their extent of locational or maturity mismatch would be implemented whenever trip wires revealed the early emergence of these vulnerabilities.

In cases where foreign loans have been significant, economic reforms that promote growth could replace the resources initially lost if there is a reduction in foreign borrowing due to the measures described above. Governments and central banks that take steps to restrict foreign borrowing can replace at least some of the finance that is forgone by implementing measures that increase their ability to mobilize and channel domestic saving to projects that are central to a pro-poor growth agenda. In this connection, measures that restrict the exit options of domestic savers and businesses would increase the pool of capital available domestically.

There is a strong case for restricting the access of domestic savers to foreign capital markets. The flight of domestic investors can induce financial instability, and reduce the tax base and the pool of domestic savings available for allocation by domestic financial institutions. For these reasons, there is a strong case for restricting the ability of domestic investors to hold foreign savings accounts and engage in capital flight.

There is plenty of evidence that when properly implemented, management of inflows and outflows of portfolio investment can enhance the ability to undertake macroeconomic policy and help achieve developmental goals. The success of blunt restrictions on portfolio investment in China, India, Chile and Colombia suggest that foreign investors do not necessarily shun countries with minimum-stay requirements on foreign investment or other types of capital management techniques. We have also seen that the tax system can be used to influence the composition and/or maturity structure of international capital flows. The potential for flight by domestic investors and savers can be reduced via implementation of exit taxes, prohibitions on flight, or restrictions on access to foreign currencies. Finally, Malaysian experience suggests that speed-bump style management of portfolio investment can be effective as well.

## 4.5 Conclusions

To reiterate, there is extensive knowledge about the kinds of macroeconomic financial policies likely to protect national economies from the instabilities of global finance and achieve their goals of promoting employment, poverty reduction and sustainable development. The main policy lessons are that:

1. central banks should implement a real targeting approach to monetary policy in order to facilitate the achievement of expansions in decent employment, enhance financial stability, and promote credit allocation to decent employment generating investments
2. Central banks should develop additional tools to achieve these goals, and furthermore, should cooperate with other arms of government to bring about these results. Central banks cannot achieve these activities alone. They must coordinate with other key governmental and private actors.)

3. Market allocation of finance needs to be embedded in strong financial regulations oftensupplemented by an important role for government guidance of finance to important sectors,
4. There are a large variety of successful ways to use the financial system to mobilize anddirect finance that make a judicious use of market incentives, government guarantees and monitoring to ensure that the finance goes to socially productive purposes and the poor
5. Central banks, along with other public financial institutions need to be involved in promoting a developmental role for finance , and
6. Capital management techniques, usually of a dynamic and flexible nature, can be a very important tool for reducing the negative aspects of global financial integration while enhancing the positive aspects.

It is crucial to recognize that different policies are likely to be more relevant to countries at different levels of development. The "level of development" is likely to affect the choice of the appropriate mix of policies and policy institutions in a number of crucial ways: 1) Government capacity will have a big impact on the complexity and breadth of government management that a country can implement 2) The over-all degree income, wealth, infrastructure and human capital will obviously affect the policy priorities governments will need to pursue 3) the mixture of agriculture, manufacturing and services in the economy, will likewise affect the transmission mechanisms of monetary and financial policy. These are just a few examples of the ways that "level of development" will play a crucial role in determining the available and useful policy options for particular countries.

The overriding message of this paper is that a wide range of macroeconomic, financial policies and experiences do exist, that policymakers can draw upon and adapt in accordance with their employment-oriented growth objectives.



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