Fallacies of Neoliberal Macroeconomic Policy Prescriptions for Developing Nations:

The World Bank's 2014 Prescription for Ethiopia as a Current Case[1]

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Motivation

It is a glitteringly presented report, full of colorful bar and line graphs throughout the body of the text. It is titled as: *3rd Ethiopia Economic Update: Strengthening Export Performance through Improved Competitiveness (June 2014)*[1], In this latest report, the World Bank (WB) advised the Ethiopian Government to devalue the Ethiopian currency, Birr (i.e., reduce its purchasing power relative to currencies of Ethiopia's trading partner countries). After reading the report, any concerned Ethiopian with basic knowledge of economics feels obligated to ask fundamental questions on credibility of the report: (1) Does the report has relevance to the war being waged against poverty? (2) *How* and *where* were the data collected? This is a crucial question, which determines credibility of the study. (3) What are the merits of devaluing currency of a country whose economy is tiptoeing at Rostow's second stage of *Pre-conditions for Take-Off*'?[2]

A statement of the renowned economist, Professor Joseph Stiglitz, winner of the Nobel Prize for Economic Sciences (2001), who was a senior vice president and chief economist of the WB (1997-2000) answers these questions in a nutshell:

> *When the IMF decides to assist a country, it dispatches a "mission" of economists. These economists frequently lack extensive experience in the country; they are more likely to have first-hand knowledge of its five-star hotels than of the villages that dot its countryside. They work hard, poring over numbers deep into the night. But their task is impossible. In a period of days or, at most, weeks, they are charged with developing a coherent program sensitive to the needs of the country. Needless to say, a little number-crunching rarely provides adequate insights into the development strategy for an entire nation.* ***Even worse, the number-crunching isn't always that good. The mathematical models the IMF uses are frequently flawed or out-of-date. Critics accuse the institution of taking a cookie-cutter approach to economics, and they're right***[3]. (Emphasis added, refer endnote for details).

In disgust of the way the WB was trying to manage economies of poor nations *intrusively*, Professor Stiglitz quit his financially rewarding position. The lopsided argument in the whole report is that devaluation of the Birr will boost Ethiopia's export earnings and thereby attain economic growth. One should not be surprised to know that the WB hires *clever-self-serving* economists, who are capable of manipulating fundamentals of the *Neoclassical Macroeconomic Theory*. This theory, which is based on many hypothetical assumptions, has several shortcomings. The hypothetical conditions – among many others are: perfectly competitive market structure, free-market economy (no government intervention), profit

[1] This piece is an extraction from a short section of my *preliminary draft of a major manuscript* on development. I will gratefully acknowledge for helpful comments to improve the work in progress. I can be reached at: global.gsnet@shaw.ca.

maximizing-rational producers, and utility maximizing-rational consumers. Thus, neoliberal policy instruments do not have any place in a tiptoeing poor economy like that of Ethiopia. Ethiopians are struggling to break poverty traps; and they understand that poverty is a multidimensional human misery. It is deprivation of *entitlements* to the essential livelihood capital assets and opportunities[4].

By contrast, development is a process, which starts with *poverty eradication*. This process involves *the best possible democratic governance system* characterized by: accountability, transparency, devolution of political power down to targeted-grassroots' communities, responsiveness to the needs of all stakeholders (particularly to those of the poor), participatory decision making, gender and material wealth equity, empowerment of the disadvantaged, efficiency and effectiveness in allocating scarce resources, and upholding the rule of law.

What does currency devaluation has to do with development? Devaluation has c*ontractionary* adverse impacts on economic activities on both the demand and the supply sides, not expansionary as neoliberal economists would like us to believe. Three reasons come to mind: (1) devaluation can redistribute income from groups with a lower (the poor) to a higher (the rich) marginal propensity to save, leading to decline in aggregate demand; (2) a nominal devaluation is likely to decrease aggregate demand through the negative real balance effect due to higher price levels, which in turn may decrease output level, say the gross domestic product (GDP); and (3) if the price elasticities of exports and imports with respect to real GDP are very low, then the trade balance expressed in terms of domestic currency may deteriorate, causing a *recessionary effect in the economy*. In addition to these demand-side effects, there are also a number of supply-side channels through which devaluation can be contractionary. For example, exchange rate depreciation (devaluation) raises the costs of imported productive inputs, such as equipment, machinery, and information and communications technologies, leading to a decrease in aggregate supply. Moreover, exchange rate depreciation may raise the domestic interest rate and wage level through an increase in market commodity price level[5]. Thus, there is no *quick fix* to economic challenges let alone in a developing country even in the developed countries.

In this piece, let me start with the historical reasons why the WB and the International Monetary Fund (IMF) were created. Then, failures and consequences of their well-known *Structural Adjustment Policies* and the *Poverty Reduction Strategy Papers*, both of which prescribed neoliberal policies for developing nations, are highlighted. Finally, I provide key closing remarks, which, I hope, will motivate the reader to do some soul searching and come-up with own views on the multidimensions of poverty and, hence, development.

Birth of Modern International Political Economy

History matters: *When, why, by whom, how, and for whose benefit* were the currently dominant global financial organizations created? I am referring to the International Bank for Reconstruction and Development (IBRD), which is currently part of WB, the IMF, and the General Agreement on Tariffs and Trade (GATT). Here is a sketch of the history on the birth of the modern *international political economy*:

Just after the social, economic, and environmental devastations of World War II, the Allied nations needed to craft financial policy instruments that stabilize and ensure growth of their respective economies. 730 delegates from all 44 countries that had formed alliance against Hitler gathered in the United States from July 1-22 July 1944 at the Mount Washington Hotel, Bretton Woods Township in the State of New Hampshire, a state named after the southern

English county of Hampshire. The conference was dubbed as the United Nations Monetary and Financial Conference, although it was of the Allied nations only.

The IMF was mandated to ensure the new financial policy instruments were implemented as stipulated in the agreements, which included, "*The nations should consult and agree on international monetary changes which affect each other. They should outlaw practices which are agreed to be harmful to world prosperity, and they should assist each other to overcome short-term exchange difficulties*" (emphasis added). The IBRD was expected to speed up post-war economic reconstruction and growth, to aid political stability, and to foster peace, all to be fulfilled through establishment of programs for reconstruction and development. Free market economies and joint management of the Western socioeconomic and political order were the key goals of the Conference. The Conference's outcomes included: formation of IBRD/WB and IMF, fixed exchange rates with some provisions for adjustments if necessary, convertibility of currencies, freedom of national governments to revise exchange rates up to 10%, and subscription of member countries to the IMF's capital.

Structural Adjustment Policies and Poverty Reduction Strategy Papers

Structural adjustment policies (SAPs)

SAPs are socioeconomic policy changes that the IMF and WB used to impose on developing countries between the 1970s and the late 1990s. Experts of the agencies argued that their prescriptions always aimed at: stabilizing the macroeconomic environment, promoting economic growth and alleviating poverty, advancing open and free market economies, arguing for good governance, improving resource allocation efficiency, creating conditions for private sector development, and building national capacity for policy analysis. But, these seemingly well intended justifications ought to be examined in relation to the conditions that IMF and WB imposed on the poor countries.

In the late 1970s, a series of global economic crises occurred. They included unexpected jump of oil price; multiple economic depressions, and stagflation (monetary inflation without growth of industrial output, supply, rising inflation along with rampant unemployment). Impacts of these fiscal and economic crises on the economies of the poor countries were disastrous. Consequently, national policymakers of these countries were compelled to accept *neolibera*l requirements prescribed by experts of IMF and WB.

In order to qualify for new loans and/or lower interest rates on existing loans, the poor countries were asked to enter into legally binding contractual agreements to meet the following conditions – among others: (i) cut public expenditures; (ii) adopt strict policies of *austerity*, meaning reduce public expenditures on development projects, such as healthcare, education, and infrastructure; (iii) focus national-economic output on direct export of unprocessed natural resource and agricultural products, such as: logs, semi-processed lumber, diamond, copper, gold, cotton, flowers, cocoa, coffee, and soybean; (iv) devalue national currencies (the subject of this article); (v) liberalize market by lifting all import and export restrictions; (vi) stabilize investment climate to encourage foreign direct investment (FDI) by leaving domestic market wide open for foreign companies, the multinational corporations, to enter and/or exit as they see it fit to their profit maximization motives; (vii) adopt balanced budget policy, a deficit free economy; (viii) remove price controls and public subsidies; (ix) privatize and/or sell all or part of state-owned enterprises: *a push to divestitures* i.e., divestment (disinvestment) process, which is a serious macroeconomic policy, with serious consequences; (x) secure rights of foreign investors, vis-à-vis national laws; and (xi) ensure good governance.

Many developing countries, including Ethiopia, objected the SAPs prescriptions imposed on them for a number of reasons, including the following: (i) national sovereignty interference, authoritative rights of sovereign governments to manage their respective economies following their respective social, economic, political, and environmental objective realities were restricted by the imposed *conditionalities*; (ii) the agricultural sector's failure to produce sufficient food grains (there are several reasons on this only); (iii) degradation of the natural environment and the adverse effects of climate change caused by massive emissions of greenhouse gases (GHGs) to which the poor nations contribute almost nothing; (iv) gender equity: imposed austerities caused withdrawal of public funds from social spending on education, health, family planning, sanitation, clean water supply, and local infrastructure development; and (v) the imposed national currency devaluation prescription had adverse impacts on that currency's power to purchase capital goods necessary for development, such as equipment, machinery, and ICT technologies.

Poverty Reduction Strategy Papers (PRSPs)

To continue lending money to poor countries, the WB and the IMF devised new strategy, development of PRSPs in 1999, replacing the objectionable SAPs. This approach seems simple in concept, but potentially radical in its implications for development assistance. The basic idea is that governments seeking concessional lending from the WB and IMF must prepare their own PRSPs. Loan seeking countries were advised to prepare their PRSPs through participatory processes, involving both domestic stakeholders and external development partners. The PRSP approach was described as nationally owned, comprehensive, and long-term development partnership. But, wait. Let us examine the fallacies.

First, the rules set by WB and IMF. Their guidelines for the PRSP required that each government seeking concessional assistance and debt relief should first present an *Interim PRSP* that describes its poverty situation, its existing policies, and its plans to develop a first full PRSP through a participatory process. The first full PRSP should describe the participatory process by which it has been produced, evaluate the dimensions and causes of poverty, set targets for poverty reduction and indicators to monitor progress, and outline the priority public actions for reducing poverty. In short, the WB and IMF experts, as advised by their respective bosses, advocated that the client poor-countries accept the PRSPs as: country-driven (owned), results oriented, comprehensive in scope, participatory, and partnership-based. PRSPs, bearing these and similar were qualified for the HIPC (highly indebted poor country) and loans. But, the fallacious, delusive, words and phrases, such as "country-owned, participatory, poverty reduction strategy, and partnership-based", were instruments used to trap gullible political leaders in legally binding contractual agreements to pay back the loans.

Concluding Remarks

Focusing on the problems associated with the SAP and PRSP prescriptions, I would like to provide key concluding remarks. I use the following seven problem headings, based on the fundamentals of macroeconomic theory:

1) ***Duplicity of enhanced participation and economic alternatives***: WB and IMF impose a great deal of emphasis on the need for participatory processes in formulating the PRSPs. Enhanced participations are certainly essential to build more effective strategies. But, in most case,

participation has been mostly a government sponsored one-of consultation with civil-society organizations and community groups, designed to elicit a rubber stamp for strategies already formulated.

2) The illusory goal of 'national ownership' of economic policies**:** The WB and IMF as well as the donor community at large often proclaim the need for national 'ownership' of poverty reduction strategies, including the PRSPs. What is missing, however, is national empowerment over policy formulation, not merely national 'ownership' under the auspices of external forces. National 'ownership' of such strategies is a donor obsession, not a government objective. Governments were being urged to adopt "as their own" policies introduced by outside agencies.

3) A small government as is the problem, not the solution**:** A small-government bias governs all neoliberal economic reforms. The SAPs (described earlier) led to substantial downsizing of the state in many developing countries—debilitating their capacities to formulate and implement the pro-poor policies that are now required for PRSPs. Tax reforms have combined with recessions to depress the revenue levels for many governments. Cutting expenditures has been heartily endorsed, especially for public administration, but raising taxes has been only mildly supported. As a consequence, many governments in developing countries lacked enough revenue to invest in growth and fight poverty. A pervasive 'small-government ideology' masks the reality that governments are starved of resources, unable to adequately finance many essential public services. Poor households end up as the main losers.

4) The key role of public investment in growth and poverty reduction: In most developing countries, more expansionary fiscal policies are needed to accelerate economic growth. Fiscal policies are also needed to play a counter-cyclical role in stabilizing the economy. Moreover, the growth stimulated by fiscal expansion can help generate the fiscal revenue needed to close any deficits incurred in the process of expansion, depending on the elasticity of taxes with respect to GDP. Such policy recommendations were based on the assumption that the economies of most developing countries were demand-constrained, not price-constrained. An economy is demand-constrained when its level of output is limited by the components of aggregate demand variables, namely: consumption, private investment, government expenditures and net exports. In such an economy, the set of relative prices derives from the level of aggregate demand and changes in response to the rise or fall of aggregate demand. Relative prices are not 'signals' to producers and consumers but result from production and consumption decisions. When total aggregate demand is deficient, active fiscal policies play a central role in moving the economy towards full employment and generating a higher growth rate. Within this context, public investment plays a crucial role in accelerating the rate of economic growth, both by providing a demand stimulus to the economy and expanding its productive capacity. Such investment can also play an important role in allocating resources to the poor—it can give the pattern of growth a more pro-poor character. Thus, public investment is essential to a pro-poor and pro-growth economic strategy for three major reasons: demand management, capacity creation, and redistribution.

Incidentally, public investment is not the enemy of private investment, as neoliberal economists claim. Public investment in social and economic infrastructures is a prerequisite for private investment expansion. Neoliberal economists also argue that increasing public investment will enlarge public deficits and that these, in turn, will fuel higher inflation, depreciation of the exchange rate and higher real rates of interest. However, there is little empirical evidence that shows public investment *crowds out* private investment through changes in the interest rate or exchange rate. Moreover, the multiplier impact of public investment can be potent enough, if there is excess capacity in an economy and households are in need of monetary support. It is amazing to observe the hypocrisy of many economic advisors from rich-countries. They often argue against expansionary fiscal policies in poor countries. But, these are the very policies they recommend and implement in their own rich countries.

***5) Tight inflation targets are roadblock to growth*?** The multipliers for fiscal expansion remain large particularly when a moderate monetary expansion accompanies an increase in public investment. However, neoliberal economics is biased towards tight monetary policies. Slow growth and low employment hurt the poor more than anyone else. Inflation is not their only problem. While moderate inflation can be compatible with growth, both low and high inflation can be harmful. When low-inflation policies drive an economy into recession, the poor lose out, often for years thereafter. Money is too important to be left to central bankers. Without jobs and income, people cannot benefit from price stability. Inflation targets should be determined, not independently by technocrats, but by government-wide and democratic decision-making. The monetary specialists can then be left to craft the means. Most developing countries have been advised to reduce their annual inflation rate to a 3-5 per cent range—a usual conditionality for obtaining access to concessionary loans. The danger created by deflation is that it can precipitate a self-reinforcing downward spiral of prices, profits and incomes, from which it is difficult for policymakers to extricate an economy. Monetary policies are usually ineffective when an economy has slipped into such a "liquidity trap". Thus, it is better to prevent deflation than to try to combat it once it sets in. For such a purpose, it is often necessary to deploy counter-cyclical fiscal policies. Once deflation is entrenched, expansionary fiscal policies are also more reliable than monetary policies in reviving the economy.

6) The dismal record of financial liberalization (deregulation): One of the cornerstones of neoliberal economic reforms has been radical financial deregulation. But the record of such deregulation has been neither pro-poor nor pro-growth. It has often destabilised the economies of developing countries and denied access of poor households to credit**.** Under liberalization, real interest rates were observed rising and the spread between the deposit and lending rates of interest has been widening. Commercial banks have tended to concentrate their activities in a few urban areas, depriving the rural population of access to financial services, and thus making access to credit more inequitable than before liberalization. Banks have been reluctant to lend in rural areas, especially if the rural economy is stagnant. Under liberalization, banks and corporations resort more to short-term external borrowing, making the country more vulnerable to short-term capital flight—and wreaking havoc on the economy in times of crisis. When the economy is booming, 'hot money' rushes in to make a quick profit, but this sows the seeds of financial instability.

***7) The dubious contributions of privatization*:** Privatization of state-owned enterprises (SOEs) and other publicly owned assets, such as land and housing, has been an integral component of neoliberal economic reforms. The justification has been that public ownership of assets is inefficient because it distorts incentives, hampers resource allocation and impedes innovation. In addition, it is alleged that state-owned enterprises are a drain on public resources and a source of rent-seeking and corruption. However, the evidence on the contributions of privatization to efficiency and effectiveness remains unproven convincingly. In some cases, efficiencies can be improved without changing ownership of assets. Privatization appears to be less important, in most cases, than competition and regulation. Once the latter two factors are taken into account, the contribution of privatization to efficiency is often statistically insignificant.

Also, the long-term impact of privatization on government budgets remains unclear—especially when profitable SOEs, which are the most attractive to private buyers, are sold at cheaper sale prices, as is the case in many instances. When sale prices are low and the administrative costs of privatization are taken into account, the net proceeds from selling SOEs might well be negative. In addition, over the long term, the taxes paid by privatized firms, which are likely to be low, might not compensate for the loss of the profits of the SOEs. Moreover, the balance sheet would be even more negative if the costs of regulation of the privatized firm were taken into account. Little research has been done, until recently, on the distributional impact of privatization, particularly on the poor. Privatization of the provision of public services, such as water, telephone, energy, health, and education has often led to reduced distributive coverage and higher prices for poor households.

Finally, I believe we agree that it is a global fact neoliberal conditionality-based policies continue to perform very poorly – particularly in the developing countries. Persistently pervasive chronic poverty, insignificant national development, rampant corruption, socioeconomic instability, widening inequality, persistent underemployment, environmental degradation, ecological *overshoot* of human population, institutional stickiness, and overused and fragmented farmlands continue to characterize the developing world. In relative terms, however, the Ethiopian situation reflects a bright future. As many agencies, including WB and IMF, reported Ethiopia's *Growth and Transformation Plan*, which is rooted in the objective realities of the country, is performing well. Ethiopia is **not** expected to embrace neoliberal-market-conformity prescriptions. The ongoing *multi-front strategy* will enable Ethiopia to eradicate poverty and all other social ills from her landscape soon!

ENDNOTES

[1] Retrieved from: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/07/18/000470435_20140718101850/Rendered/PDF/895480WP0Wb03d00Box385285B00PUBLIC0.pdf on 01 Aug. 2014

[2] Walt Whitman Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto* (Cambridge: Cambridge University Press, 1960), Chapter 2, "The Five Stages of Growth-A Summary," pp. 4-16. Rostow's model postulates that economic growth occurs in five stages at varying lengths of time: *Stage 1*: *Traditional Society*, characterized by subsistence agriculture, or hunting and gathering, almost wholly a "primary" sector economy, limited technology, and a static or "rigid" society; *Stage 2*: *Preconditions to Take-Off*, characterized by: importing some technology and raw materials for economic change initiatives, commercial agriculture and cash crops, basic infrastructures, spread of technology, and developing nationalism; *Stage 3*: *Take-Off*, characterized by: urbanization, industrialization, technological breakthroughs (inventions and innovations), the *Industrial Revolution* of the United Kingdom (1750-1850) is a good example; *Stage 4: Drive to Maturity*, characterized by: diversified manufacturing sector, rapid development of social and economic infrastructures, and large-scale investments; *Stage 5*: *Age of Mass Consumption*, characterized by: diminished relevance of primary sector, dominant industrial sector, high value consumer goods, dynamic and active society, aware of democratic values and good governance.

[3] Stiglitz, J. 2000. *What I Learned at the World Economic Crisis: The Insider*. The New Republic 04.17.00, for bibliographic summary go to: http://en.wikipedia.org/wiki/Joseph_Stiglitz, accessed on 09 Aug. 2014.

[4] *Development as Freedom*, Amartya Sen. Oxford, Oxford University Press, 1999, ISBN: 0 19 829758 0, 366pp. Professor Sen won the Nobel Prize for Economic Sciences (1998), among many other awards; for a short bibliography go to: http://en.wikipedia.org/wiki/Amartya_Sen, accessed on 09 Aug. 2014