

**Discussion Paper**  
**The Macroeconomics of Poverty Reduction,**  
**Initial Findings of the UNDP Asia-Pacific Regional Programme:**  
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**August 2003**

The UNDP Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction currently covers nine countries (Bangladesh, Cambodia, China, Indonesia, Mongolia, Myanmar, Nepal, Sri Lanka and Vietnam). In its first stage, it is producing policy-oriented research on the impact on poverty of macroeconomic policies (fiscal, monetary and exchange-rate policies) and adjustment policies (financial liberalization, trade liberalization, and privatisation/de-regulation).

In evaluating this impact, the research also identifies complementary policies that can enhance the impact on poverty of macroeconomic and adjustment policies. This paper reviews two complementary sectoral policies, namely, agricultural development and employment generation, which figured prominently in many of the studies. The research also investigates whether a country is able to mobilize the domestic resources (for example, through savings, taxation or borrowing) to finance a high rate of public and private investment for accelerated economic growth.

This paper presents some initial findings from the drafts of eight case studies (Bangladesh, Cambodia, China, Indonesia, Mongolia, Nepal, Sri Lanka and Vietnam). Before the end of 2003, a final synthesis report will be produced and the case studies will be submitted for professional publication.

These countries vary significantly—such as in terms of size, income level and economic structure. For example, China's gross national income was \$1,131 billion in 2001 while Mongolia's was one billion and Cambodia's 3.3. Half of the countries—

Cambodia, China, Mongolia and Vietnam—have been undergoing a transition from a centrally planned economy to a regulated market economy.

Income per person in these countries ranges from a low of \$1,310 in Nepal and \$1,610 in Bangladesh to \$3,180 in Sri Lanka and \$4,020 in China (Table 1). Some of the countries have become relatively industrialized. The share of industry in GDP in China is 51 per cent, in Indonesia 47 per cent and in Vietnam 38 per cent. Despite progress, Bangladesh, Cambodia and Nepal still have a low level of industrialization. Mongolia has undergone a process of de-industrialization, as its share of industry in GDP dropped from 30 per cent to 17 per cent between 1990 and 2001.

Some of the countries have become very dependent on external trade. In Cambodia, for instance, trade in goods as a percentage of GDP rose from about 22 per cent in 1990 to almost 92 per cent in 2001. Vietnam has a similarly high ratio, i.e., almost 94 per cent, in 2001. Also, the ratios for Indonesia, Mongolia and Sri Lanka are 60 per cent or higher. In contrast, Bangladesh and Nepal are less reliant on trade: Bangladesh's ratio is 32 per cent and Nepal's almost 40 per cent.

**Table 1: Some Basic Economic Indicators**

<b>Countries</b>	<b>GDP Per Capita (PPP US\$) 2001</b>	<b>GDP Per Capita Annual Growth Rate (%) 1990-2001 (2000-2001 in parentheses)</b>	<b>Average Annual Change in the CPI (%) 1990-2001 (2000-2001 in parentheses)</b>	<b>Trade in Goods as % of GDP 2001 (1990)</b>
<b>Bangladesh</b>	1,610	3.1 (3.5)	5.1 (1.1)	32.0 (17.6)
<b>Cambodia</b>	1,860	2.2 (4.2)	5.3 (-0.6)	91.7 (22.4)
<b>China</b>	4,020	8.8 (6.5)	7.6 (0.3)	44.0 (32.5)
<b>Indonesia</b>	2,940	2.3 (2.0)	13.9 (11.5)	60.1 (41.5)
<b>Mongolia</b>	1,740	-0.2 <sup>1</sup> (0.4)	39.0 (8.0)	67.8 (-)
<b>Nepal</b>	1,310	2.4 (2.4)	8.1 (2.8)	39.7 (24.1)
<b>Sri Lanka</b>	3,180	3.6 (-2.8)	9.9 (14.2)	67.5 (57.3)
<b>Vietnam</b>	2,070	6.0 (5.5)	3.2 (-0.4)	93.6 (79.7)

Source: World Bank, World Development Indicators 2003 (Columns 2(2000-01:Table 1.1), 4 (Table 6.1)) and Human Development Report 2003 (Columns 1 (Table 1), 2(1990-2001:Table 12), 3 (Table 12)). Footnote 1: estimate.

China and Vietnam achieved rapid rates of growth in income per capita from 1990 to 2001. China's rate was 8.8 per cent and Vietnam's 6.0 (Table1). However, growth in Cambodia, Indonesia and Nepal was much slower, ranging between 2.0 and 2.5 per cent. Growth has slowed down in China and Vietnam during 2000-2001 but picked up in Cambodia. In Mongolia growth is at a standstill while in Sri Lanka it has turned negative.

During this period, inflation was not a major problem, except in Mongolia. The inflation rate for Mongolia during 1990-2001 was about 40 per cent. In Indonesia it was about 14 per cent but for the rest of the countries it was below 10 per cent. During 2000-2001, the inflation rate slowed down in all countries, except in Sri Lanka. Inflation had become very low or negative in several of them. Deflation was a problem in Cambodia (-0.6 inflation rate), and Vietnam (-0.4) while inflation was very close to zero in China and only about one per cent in Bangladesh.

According to the Human Poverty Index, deprivation remains a widespread problem in Bangladesh, Cambodia and Nepal: over 40 per cent of the population remains deprived, on average, of basic human capabilities (Table 2). A similar story is registered by the international poverty measure of one dollar a day per person. China has the lowest level of human poverty among the eight countries but Indonesia and Sri Lanka have the lowest level of poverty according to the one-dollar measure.

Bangladesh, China and Vietnam have had notable success in reducing income poverty during the 1990s. Table 2 records progress in poverty reduction based on national poverty lines. In Bangladesh, the proportion of the population in poverty declined from 50 per cent in 1991-92 to 40 per cent in 2000. China scored a much more rapid rate of poverty reduction, based on a faster rate of economic growth and supplemented by favourable agricultural terms of trade during the mid 1990s. The proportion of the Chinese population in poverty dropped from about 31 per cent in 1990 to 11.5 per cent in 1998, with most of the progress being registered between 1993 and 1996. In Vietnam, the proportion of the population in poverty declined from 51 per cent to 37 per cent during the relatively short period between 1993 and 1998.

In Cambodia, Indonesia and Mongolia, there was very little progress in reducing income poverty. In Cambodia growth of per capita income was slow during most of the

1990s and concentrated in urban areas. Because of the setbacks that Indonesia experienced during the Asia Financial Crisis, the level of poverty in 2000 was virtually the same as it was in 1993; during the crisis it had doubled. Mongolia underwent a deep recession in the early 1990s and recovered only slowly thereafter, with little discernible impact on poverty. In Nepal and Sri Lanka poverty appeared to rise during part of the 1990s.

**Table 2: Poverty Measures**

<b>Countries</b>	<b>Human Poverty Index (HPI-1) Value (%)</b>	<b>Population Below Income Poverty Line \$1 a day (1990-2001)</b>	<b>Share of Population that is Poor, By National Poverty Line, (Earliest Year)</b>	<b>Share of Population that is Poor, By National Poverty Line, (Latest Year)</b>
<b>Bangladesh</b>	43	36	50 (1991-2)	40 (2000)
<b>Cambodia</b>	43	--	39 (1993-4)	36 (1997)
<b>China</b>	14	16	31.3 (1990)	11.5 (1998)
<b>Indonesia</b>	18	7	34 (1993)	34 (2000)
<b>Mongolia</b>	19	14	36.3 (1995)	35.6 (1998)
<b>Nepal</b>	42	38	40 (1989)	45 (1996)
<b>Sri Lanka</b>	18	7	20 (1990-1)	25 (1995-6)
<b>Vietnam</b>	20	18	51 (1993)	37 (1998)

Source: UNDP, Human Development Report 2003 (Columns 1-2: Table 3), Case Studies (Columns 3-4)

Drawing on the draft case studies of the eight countries, this paper briefly addresses seven issues: 1) investment-led fiscal policy 2) restrictive inflation targeting 3) low revenue/GDP ratios 4) the neglect of agricultural and rural development 5) the poor record of financial liberalization 6) the key role of employment and 7) pro-poor trade policies.

The objective of the regional programme is to broaden the policy dialogue on the prerequisites for pro-poor growth and promote greater consistency between countries' Poverty Reduction Strategy Papers and their macroeconomic and adjustment policies.

Hopefully, the lessons from the regional programme in Asia-Pacific can contribute to developing a general outline of a macroeconomic framework that is more

aligned with the objective of pro-poor growth and human development. It is evident that the initial findings have begun to diverge in significant respects from reigning ‘Neo-Liberal’ orthodoxy, which has generally been unable to produce either rapid growth or substantial poverty reduction.

UNDP’s basic approach to Pro-Poor Growth Strategies stems from its 2002 Policy Note, “The Role of Economic Policies in Poverty Reduction” (UNDP 2002). This policy note concentrates on how growth is generated and whether this process is equitable. Its focus is on the economic opportunities of the poor, namely, their access to assets, resources and employment that enable them to secure a decent material standard of living and thereby significantly widen their options for human development.

The policy note takes the position that if countries are to reach the target of halving extreme income poverty by 2015 (the primary poverty goal of the Millennium Declaration), rapid growth is certainly essential—more rapid, in fact, than the average of the last three decades. However, if growth is more equitable—so that the incomes of the poor grow faster than average—countries have a much better chance of reaching the target.

Hence, a strategy of such “equity-based” growth will need to be rapid enough to significantly improve the ‘absolute’ condition of the poor and equitable enough to improve their ‘relative’ position—preferably by achieving equity at the start of the growth process (such as through land reform or universalising basic education) or by decreasing high inequality over time (such as through pushing up wages by generating widespread employment among low-skilled workers).

“Equity-based” growth can be achieved through a variety of strategies, which obviously depend in part on each country’s initial conditions. In general, if growth is to immediately reduce poverty, it should have a pattern that directs resources disproportionately to the sectors in which the poor work (such as small-scale agriculture), the areas in which they live (such as underdeveloped regions) or the factors of production that they possess (such as unskilled labour or land).

A strategy that posed such an immediate objective would be strongly equity-driven in its early stages and tend to be bottom-up in its impact—directly reaching the poor where they are to be found. Although employment might be generated, the rise of

real incomes might, however, be slower than optimal. Nevertheless, the character of whatever growth is achieved would decidedly improve the relative position of poor households.

The longer-term objective of all development is to move the workforce, and poor workers in particular, out of low-productivity sectors, poorly resourced regions and low-skilled employment. In most cases, this would imply moving poor workers out of agriculture and into industry and a more modern service sector.

If industry is able to grow rapidly enough and generate employment broadly enough, poverty will be reduced as a result of the movement of poor workers into higher-productivity, higher-paid jobs. In the past, import-substitution strategies have succeeded in achieving this effect in some countries. Nowadays, some strategies based on emphasizing the exports of manufactures have been successful. In the short run, inequality is not likely to be reduced—and may even rise. If inequality is indeed reduced, it is more likely to be due to initial prosperity in agriculture or an initially equitable distribution of endowments, such as land or human capital.

In examining the impact of macroeconomic and adjustment policies, the UNDP-supported case studies are directly concerned with these vital issues of growth and inequality, and their interaction. Generally, their policy recommendations favour more expansionary, investment-focused fiscal policies and more accommodating monetary policies than ‘Neo-Liberal’ orthodoxy. The Pro-Poor Growth Strategies that they tend to advocate put a premium on boosting domestic savings and investment (instead of the orthodox focus on allocative efficiency and price stabilization), and using public investment as a stimulus to private investment.

This implies a more activist policy role for the state and a larger revenue base, with which it can finance capital expenditures and direct them to poverty-reduction purposes. The case studies tend to be critical of the impact of conservative policies of financial liberalization, both domestic and external, and favour capital controls, stronger regulation of the financial sector and some scope for directed credit, especially for poverty-reduction purposes.

The case studies give trade liberalization mixed reviews. Compared to financial liberalization, greater trade openness has had, in some countries, a more positive impact

on growth and poverty reduction. However, this has often been combined with import substitution policies.

If trade liberalization is not complemented with other more pro-active measures (especially poverty-focused interventions), such as the building of rural infrastructure, financing of agricultural development or the provision of adequate credit to small and medium enterprises, trade liberalization can exacerbate inequality and bypass the poor, especially the rural poor. To be most effective, liberalization of trade should be designed carefully and go hand-in-hand with a pro-active industrial strategy.

In many countries, the case studies find that agricultural and rural development is a crucial underpinning of a Pro-Poor Growth Strategy yet such development is often ignored in the allocation of public resources and in Poverty Reduction Strategy Papers. For Neo-Liberalism, “agricultural-led” growth seems to be anathema, yet in the initial stages of launching into a dynamic of rapid and sustainable growth, some of the most successful developing countries have incorporated key aspects of just such a strategy.

Employment generation also seems to appear as a distant blip on the radar screen of Neo-Liberalism. Despite the widespread rhetorical commitment to “Pro-Poor Growth”, employment is often a “missing link” in the chain that connects growth to poverty reduction. This is *prima facie* evidence that a deep-seated inconsistency remains between the orthodox stabilization-fixated growth strategies, on the one hand, and national poverty reduction strategies, on the other hand.

In trying to link growth to poverty reduction, the UNDP-supported case studies invariably have to address the importance of generating widespread employment. But such employment has to be at decent wages to be poverty reducing. This implies that self-employment and micro-enterprises (and the micro-finance services supporting them) cannot serve as the foundation for a Pro-Poor Employment Strategy. Although such micro programmes can help raise incomes, secure and remunerative employment cannot be sustained by these interventions alone. The emphasis has to shift to small and medium enterprises, and large enterprises that are employment-intensive and skill-enhancing.

The following sections examine in more detail the seven issues that form the heart of this paper.

## **1. Expanding Pro-Poor Public Investment**

A major initial finding of the regional programme—which has been a fairly consistent theme across the case studies—is the need to use fiscal policy more pro-actively to expand pro-growth and pro-poor public investment. In several countries, capital expenditures are a small percentage of total government expenditures. In South Asia, for instance, this percentage is only nine per cent. By contrast, in East and Southeast Asia, it is much higher, namely, 24 per cent. In Vietnam, in particular, it is 32 per cent.

The case studies generally assume that public investment can, if it is reasonably growth-oriented, have a “crowding-in” effect on private investment. Boosting aggregate demand through public investment can have the advantage not only of sparking recovery in a stagnant economy but also loosening the supply constraints on long-term growth. However, “crowding-in” cannot be automatically assumed. Public capital expenditures have to be carefully designed as part of a well conceived pro-growth as well as pro-poor strategy.

The multipliers for expenditures on public investment can be substantial if such investment helps boost the productivity of labour and capital. The higher marginal propensity to consume in developing countries—compared to industrial countries—is an additional factor that can increase these multipliers (Hemming, Kell and Mahfouz 2002, p.12). Also, the multiplier impact of public investment can be powerful if there is excess capacity in an economy and households are liquidity constrained—as is the case in many developing countries.

The common concern of Washington-Consensus economists has been that increasing public investment will enlarge public deficits and these, in turn, will lead to higher inflation, depreciation of the exchange rate and higher real interest rates. There is little evidence in the literature that public investment crowds out private investment through changes in the interest rate or exchange rate (Ibid., p. 36). Moreover, multipliers remain large, and crowding out is minimized, when a moderate monetary expansion accompanies an increase in public investment. As long as deficits are used to finance public investment that expands aggregate supply, the aggregate demand effects should not be unduly inflationary.

Public investment can also be a powerful instrument for the re-allocation of public resources to poverty reduction. As part of its National Poverty Alleviation Strategy, for example, China has used public investment to channel funds to the poorer western regions of the country, which have been left behind by the economic boom centred in the richer coastal provinces.

In Cambodia, the case study argued that increased public investment is not likely to trigger high inflation since much of the capacity of the economy is under-utilized (especially land and labour) and adequate resources can be mobilized through domestic borrowing to finance the investment. Moreover, inflation was not an immediate problem since it was a negative 0.6 per cent in 2000-2001.

While Cambodia has been growing, poverty has not been significantly reduced because, in part, growth has been centred in urban enclaves, based mostly on the exports of garments. Demand expansion, driven by public investment, is needed to generate a broader pattern of growth that can reach rural areas, where most of the poor live.

The picture is very similar in Nepal, where market liberalization has been insufficient to generate dynamism in agriculture, where majority of the poor work. Deprived of public investment, agricultural growth has barely kept up with the growth of the rural population.

As a share of GDP, gross capital formation is not very low in either Cambodia or Nepal (Table 3). In Cambodia it was 18 per cent in 2001, an increase from a very low eight per cent in 1990. In Nepal it was 24 per cent in 2001, up from 18 per cent in 1990. However, the main problem is that this investment is not reaching rural areas, where most of the poor are located.

An additional problem is that neither country is generating enough domestic savings to finance its investment. While investment in Cambodia was 18 per cent of GDP in 2001, savings was only 10 per cent (Table 3). Similarly, while investment in Nepal was 24 per cent, savings was only 15 per cent. Consequently, in both countries, investment is aid dependent. In Nepal foreign aid amounted to 29 per cent of gross capital formation in 2001 and in Cambodia a very large 67 per cent.

In Mongolia, the story has been similar. While gross capital formation, as a percentage of GDP, has been reportedly high, namely, 30 per cent in 2001, domestic

savings has been much lower, at 14 per cent. At the same time, Official Development Assistance has amounted to over two thirds of gross capital formation (Table 3). ODA and FDI together accounted for almost all of domestic investment. The same is true in Cambodia.

**Table 3: Investment, Savings and External Capital**

<b>Countries</b>	<b>Gross Capital Formation as % of GDP 2001 (1990)</b>	<b>Gross Domestic Savings as % of GDP 2001(1990)</b>	<b>FDI as % of Gross Capital Formation 2001</b>	<b>ODA as % of Gross Capital Formation 2001</b>
<b>Bangladesh</b>	23(17)	16(10)	0.7	9.5
<b>Cambodia</b>	18(8)	10(2)	18.6	67.1
<b>China</b>	38(35)	40(38)	10.1	0.3
<b>Indonesia</b>	17(31)	26(32)	-13.2	6.1
<b>Mongolia</b>	30 (38)	14 (9)	20.0	67.5
<b>Nepal</b>	24(18)	15(8)	1.4	28.8
<b>Sri Lanka</b>	22 (23)	15 (14)	4.9	9.4
<b>Vietnam</b>	31(13)	29(13)	12.9	14.2

Source: World Bank, World Development Indicators 2003 (Tables 4.9, 4.9, 5.2, 6.10)

In Indonesia, for roughly a quarter century public investment in rural areas helped spread broadly the benefits of growth, even when growth was driven by urban-based manufactured exports in the 1980s. But such capital expenditures have been in decline since Indonesia began liberalizing its economy, especially its financial sector, in the late 1980s. Gross capital formation as a percentage of GDP dropped from 31 per cent in 1990 to 17 per cent in 2001.

Capital expenditures as a share of total government expenditures dropped from 43 per cent in 1990 to 24 per cent in 2000. The growth rate of GDP dropped correspondingly to 3.8 per cent in 1990-2001(compared to 6.1 per cent during 1980-1990). Since the Asia Financial Crisis, growth has remained low, especially in recent years—e.g., 3.3 per cent in 2001 and 3.7 per cent in 2002.

For Indonesia, the UNDP-supported case study calls for a new investment-led growth strategy that can use public investment as the lever to lift Indonesia back onto a higher growth path—instead of relying on the current strategy, which is heavily reliant on

attracting foreign capital. In 2001, foreign direct investment made a negative contribution to domestic investment—an indication of the notorious unreliability of foreign sources of capital, certainly since the Asia Financial Crisis.

The financing of the investment advocated by the UNDP-supported study would come from boosting tax revenue back up to the levels of earlier decades. Because of the effect of the balanced-budget multiplier, raising more tax revenue to finance increased public investment could still have a powerful impact on the economy. However, these policy recommendations fly in the face of the Neo-Liberal campaign to radically downsize the state.

China and Vietnam have achieved high rates of economic growth, largely due to high rates of investment. In 2001, the share of gross capital formation in GDP was 39 per cent in China and 31 per cent in Vietnam. Both countries have been able to finance most of this investment with domestic savings. In 2001, gross domestic savings were 40 per cent of GDP in China and 29 per cent in Vietnam. In China, ODA has played virtually no role in financing domestic investment while FDI has financed about one tenth of it (Table 3). In Vietnam ODA and FDI together have accounted for over one fourth of domestic investment.

## **2. Complementing Fiscal Policy with Less Restrictive Inflation Targets**

Most of the countries studied by the regional programme have adopted fairly restrictive inflation targets. Monetary policy is customarily geared to achieving an inflation rate in the range of 0-5 per cent.

As a result, several of the countries—even some of the more rapidly growing ones—have recently faced the danger of deflation (a generalized, sustained decline in the price level). This has been the case in Cambodia and Vietnam, where the inflation rates in 2000-2001 respectively were  $-0.6$  per cent and  $-0.4$  per cent (see Table 4). During the same years, Bangladesh and China have had very low inflation rates: Bangladesh's rate was 1.1 per cent and China's 0.3 per cent.

Only Indonesia and Sri Lanka had inflation rates above 10 per cent (i.e., 11.5 per cent and 14.2 per cent respectively). The Sri Lanka case study argues that inflation there is driven by cost-push factors, not the growth of high-powered money, which is the

customary Neo-Liberal explanation. It claims that monetary policy should target market interest rates (since these pose costs to private corporations), not the money stock. In the Sri Lankan case, conventional anti-inflation policies have been attacking the wrong cause of inflation.

The problem of deflation in Asia has been compounded by the recent slowdown in the world economy. This is the second time in recent years that deflation has posed a danger. The Asia Financial Crisis prompted the first. The risk of deflation in Asia has increased in the last few years and remains the highest for any region.

In developing countries as a whole, the average inflation rate has declined over the past decade to its lowest level since the 1960s. In many of them, there is little protection left against the onset of deflation, which could be triggered globally by a significantly large negative demand shock.

**Table 4: Inflation and Interest Rate**

<b>Countries</b>	<b>Average Annual Change in the CPI (%) 1990-2001 (2000-2001 in parentheses)</b>	<b>Real Interest Rate (%) 2001</b>
<b>Bangladesh</b>	5.1 (1.1)	14.0
<b>Cambodia</b>	5.3 (-0.6)	19.9
<b>China</b>	7.6 (0.3)	5.8
<b>Indonesia</b>	13.9 (11.5)	5.3
<b>Mongolia</b>	39.0 (8.0)	19.8
<b>Nepal</b>	8.1 (2.8)	4.4
<b>Sri Lanka</b>	9.9 (14.2)	5.5
<b>Vietnam</b>	3.2 (-0.4)	6.6

Source: World Bank, World Development Indicators 2003 (Tables 4.14 and 5.7).

In relatively open economies, such as those of Cambodia and Nepal, monetary policy is not an independent instrument. The Cambodian economy is highly dollarized and the Nepalese economy is closely integrated with India's. In Cambodia the target rate

of inflation has been four per cent. But, as mentioned, during 1999-2001 deflation has been the main problem, not high inflation. Tight monetary policies have been a contributing factor in driving up the real rate of interest, which was almost 20 per cent in 2001 (Table 4). Bangladesh faces a similar problem, with a real rate of interest of 14 per cent in 2001. Such high real rates of interest depress the potential for growth.

In countries such as China and Vietnam, where the development strategy largely relies on export-led growth, monetary policy is subservient to maintaining a stable exchange rate. These governments are also concerned about the potentially adverse social and political consequences of high inflation.

Thus, these two governments have accorded a high priority to containing inflation. However, both countries have recently maintained such restrictive monetary policies that their economies have suffered from deflation. When the Government of China sharply reduced central bank lending to state-owned banks in 1998, the general price level fell.

In the late 1990s, the Vietnamese Government reined in the growth of money supply after a spike in the inflation rate (to 10 per cent) in the wake of two financial crises. As a result, deflation emerged in 2000-2001; while the inflation rate edged back up in 2002, it reached only about four per cent. Despite the danger of deflation, the Government has continued to apply excessively restrictive monetary policies.

The fixation with low inflation, on the part of even relatively successful countries such as China and Vietnam, stems partly from a concern about the potentially destabilizing effects of financial liberalization. No doubt, supply-side factors are also involved. In China, trade liberalization is contributing to low prices, as are the associated excess capacity in some state-owned enterprises and a large pool of surplus labour in rural areas. While monetary policy has become more accommodating recently and fiscal policy continues to be expansionary, the deflationary impact of the SARS epidemic has yet to be determined.

The danger of deflation, if it persists, is that it can lead to a self-reinforcing downward spiral of prices, profits and incomes, from which it is difficult for policymakers to extricate an economy. Monetary policy is rendered ineffectual because the economy has sunk into a “liquidity trap” (a term coined by Keynes). Thus, it is better

to prevent deflation than try to combat it once it becomes persistent. Once it is entrenched, fiscal policies are more reliable in turning the tide (IMF, 2003).

The Neo-Liberal recommendation to national policymakers is that they should insist on maintaining inflation rates of 0-5 per cent even though there is little empirical evidence to suggest that inflation rates above that level, or even above 10 per cent, have an adverse effect on growth. For example, the fastest period of growth for the Indonesian economy was in the 1970s, when the average annual growth rate of real GDP was 7.7 per cent. During that time, the average annual inflation rate was over 17 per cent. During the period 1990-2001, China had an average inflation rate of almost eight per cent but still grew at almost nine per cent. In Sri Lanka, inflation—especially an increase in food prices—has been highest during periods of growth and poverty reduction. An increase in food prices is likely to have a pro-poor impact on food producers in rural areas.

Although the case studies are reluctant to recommend relaxing inflation targeting too much because of the danger of jeopardizing macroeconomic stability, they also recognize that some degree of inflation is expected to accompany a growing economy. This would facilitate the adjustment of relative prices to reallocate resources from unprofitable to profitable sectors. Moreover, if monetary policies are excessively restrictive, they can nullify the potential growth stimulus of expansionary fiscal policies. Low inflation is more likely after a sustainable rate of economic growth has been achieved; trying to maintain low inflation before growth has a chance to take off is likely to throttle any economic expansion.

### **3. Mobilizing Domestic Resources for Investment**

A priority in most of the countries studied is to raise additional public revenue. Many of them have a low revenue/GDP ratio. For example, in Bangladesh revenue is only about 10 per cent of GDP and in Cambodia and Nepal it is only 11 per cent (Table 5). In several of the countries, such as Bangladesh, China, Indonesia and Sri Lanka, revenue declined from 1990 to 2000. In such circumstances, it is imperative to raise more public resources. But it is also necessary to raise this revenue in a way that will not adversely affect the poor.

In developing countries tax revenue as a ratio to GDP is about half the level of industrial countries (i.e., 18 per cent versus 38 per cent) (Tanzi and Zee, 2001). As a consequence, many states simply do not command public resources adequate to finance essential economic and social services.

Raising additional revenue is critical to financing a boost in public investment, which can generate accelerated growth. An investment-led pro-poor growth strategy hinges on three financial conditions: 1) mobilizing sufficient revenue for public investment 2) mobilizing sufficient private savings to finance private investment and 3) complementing domestic resources with stable inflows of public and private capital. Domestic borrowing can contribute to financing public investment but only as a complement to revenue mobilization.

**Table 5: Taxation**

<b>Countries</b>	<b>Total Revenue As % of GDP 2000 (1990 in parentheses)</b>	<b>Taxes on Income, Profits and Capital Gains (% of total revenue) 2000</b>	<b>Taxes on Goods and Services (% of total revenue) 2000</b>	<b>Taxes on International Trade (% of total revenue) 2000</b>
<b>Bangladesh</b>	10.2 (12.0)	11	40	23
<b>Cambodia</b>	11.0 (3.9)	--	--	--
<b>China</b>	15.3 (17.9)	6	75	10
<b>Indonesia</b>	16.0 (18.8)	59	28	3
<b>Mongolia</b>	32.6 (50.6)	12	37	7
<b>Nepal</b>	11.3 (9.0)	17	34	27
<b>Sri Lanka</b>	16.8 (21.4)	13	58	11
<b>Vietnam</b>	21.1 (16.1) <sup>1</sup>	27	34	15

Source: ADB 2002 (column 1) World Bank, World Development Indicators 2003 (Columns 2-4: Table 4.13); Footnote 1: based on UNDP-supported case study.

Nepal is an example of a country that has limited room for fiscal manoeuvre. Saddled with a low revenue/GDP ratio of 11 per cent, it also faces pressure from donors to maintain low fiscal deficits and refrain from domestic borrowing. Because its Value Added Tax has failed to generate the expected revenue, it has been forced to cut back

expenditures. While the share of social services in the budget has been protected, due partly to donor pressure, the expenditures needed for agricultural and rural development, such as irrigation, have suffered. Partly as a result, poverty levels in rural areas remain high.

In Indonesia, the revenue/GDP ratio declined from about 19 per cent in 1990 to 16 per cent in 2000. This has been due in part to the reduction of import tariffs to very low levels. International trade taxes as a whole accounted for only three per cent of total current revenue in 2000 (Table 5). Hence, the case study recommends that the initial financing for increased public investment to stimulate a higher rate of growth come from raising import tariffs across the board by 10 per cent. It also suggests other tax measures, such as reducing exemptions or raising property taxes.

In general, the case studies do not accept the Neo-Liberal assumption that taxes cannot be raised on income and wealth, which are very unequally distributed in many developing countries. In industrial countries, the ratio of income to consumption taxes is more than double that of developing countries (Tanzi and Zee, 2001). In the eight countries reviewed here, consumption taxes significantly exceed income taxes in all cases except one, Indonesia (Table 5).

In all cases, consumption taxes also exceed international trade taxes. But in some of the countries studied, revenue has declined because trade liberalization has caused a substantial reduction of trade taxes but consumption taxes, the standard alternative, have not made up the difference. There has been little effort to mobilize additional income taxes. In Sri Lanka, most of the fall in revenue—i.e., from 21 per cent of GDP in 1990 to about 17 per cent in 2001—is accounted for by a fall in receipts from trade taxes. Little has been done to compensate by raising more income taxes.

Part of the problem with income taxes in developing countries is the myriad of exemptions and deductions on such taxes enjoyed by the rich. Closing these loopholes would be part of a broader effort to have the rich pay their fair share of taxes.

Opportunities to tax wealth are often overlooked. Urban property taxes are far too low in most countries, for example. Simply registering urban property—as needs to be done in Indonesia, for instance—could help raise a significant amount of funds.

Conservative economists often argue that income and wealth taxes are less efficient than consumption taxes, but this claim rests on dubious evidence (Tanzi and Zee 2001).

In some countries, tax revenue is siphoned off to pay off external debt. The Mongolian Government generates every year a current fiscal surplus (current revenue minus current expenditures), but instead of using it to finance public investment, the Government is urged by international financial institutions to pay off the external debt (Roy 2001). Servicing public and publicly guaranteed debt eats up about 12 per cent of Mongolia's current revenue. In Nepal this percentage is 13.5 per cent and in Vietnam 17 per cent. In Sri Lanka it is about 20 per cent and in Indonesia over 22 per cent.

In some instances, governments should be allowed additional latitude—through the relaxation of conditionalities—to engage in domestic borrowing, instead of external borrowing, to finance budget deficits. This is the position of the Bangladesh case study, for example. Since Official Development Assistance has dropped, the budget deficit has risen in recent years. But the case study does not believe that financing it with domestic borrowing will run the danger of crowding out private investment—as argued by some conservative economists. Among the major reasons are that the private sector is already growing healthily and inflation has remained very low (i.e., 1.1 per cent in 2000-2001).

In contrast to the fiscal constraints faced by most of the other countries studied, Vietnam has been able to generate a substantial fiscal surplus—measuring about 4-6 per cent of GDP. This surplus has provided the savings for financing public investment.

Between 1992 and 1996, while revenue had collapsed in many other transition economies, Vietnam managed to raise total revenue (tax and nontax) as a percentage of GDP to 23 per cent (before slightly declining later to 21 per cent in 2000). The external debt that Vietnam has incurred has also been used to finance public capital expenditures, which have risen steadily from 5.5 per cent of GDP in 1995 to 10.2 per cent in 2002. Currently, Vietnam confronts large potential costs associated with restructuring state-owned enterprises and state banks, but it remains on a fairly stable fiscal path, with significant room left for continuing growth-stimulating and equity-enhancing public investment.

China has had remarkable success in financing a high share of public capital expenditures over a long period. This has been an essential condition for its sustained

rapid rate of growth. But the distribution of its total public expenditures remains regressive, with a distinct bias against rural areas.

China's tax system has also been regressive. The 1994 tax reform led, for example, to a system of fiscal transfers that disproportionately benefited rich regions. Moreover, the rural tax burden has been the heaviest for farming households, which account for most of the poor. In effect, China's National Poverty Alleviation Programme is redistributing resources back to poorer regions that the regular functioning of the fiscal system has taken away.

#### **4. Stressing Agricultural and Rural Development for Pro-Poor Growth**

In many of the countries of Asia-Pacific, agriculture remains a large and important economic sector, particularly for employment. Most of the livelihoods of the poor are tied to it. Thus, agricultural development, and rural development more generally, remain crucial for poverty reduction.

In most countries it would be difficult to achieve a more pro-poor pattern of growth without increased agricultural prosperity. Those countries, such as China, Indonesia and Vietnam, which have been most successful during certain periods in reducing poverty, have emphasized agricultural and rural development. The economic transitions in China and Vietnam started with agricultural reforms and the early success of Indonesia in dramatically reducing poverty had a great deal to do with channelling resources into rural areas, such as for basic infrastructure and social services. In addition, Bangladesh achieved its most rapid rate of poverty reduction in the 1990s largely through the impetus provided by increases in agricultural incomes.

Agricultural and rural development has suffered from the general neglect of economic services. Advocates of Human Development appear to have won a decisive battle on the importance of basic social services as a basis to reduce poverty but still have not won the war on aligning the general national budget with anti-poverty priorities. Virtually all Poverty Reduction Strategy Papers call for increased allocation of public resources to basic social services but most do not put the same emphasis on pro-poor economic services.

The importance of agricultural and rural development is highlighted by the fact that the rural population is still a large share of the total population in many countries. In Nepal this share is 88 per cent in 2001 and in Cambodia 83 per cent (Table 6). Also, the corresponding shares in Bangladesh, Sri Lanka and Vietnam are about three-quarters.

**Table 6: Rural Population and Agriculture**

<b>Countries</b>	<b>Rural Population as % of the total 2001 (1980 in parentheses)</b>	<b>Irrigated Land as % of Cropland (1998-2000) (1989-91 in parentheses)</b>	<b>Crop Production Index 1999-2001 (1989-91 equals 100)</b>	<b>Agriculture Valued Added Per Worker 1995 \$ (1999-2001) (1979-81 in parentheses)</b>
<b>Bangladesh</b>	74 (85)	48 (17)	132	311 (217)
<b>Cambodia</b>	83 (88)	7 (6)	149	363 (-)
<b>China</b>	63 (80)	40 (45)	146	334 (161)
<b>Indonesia</b>	58 (78)	15 (16)	119	744 (604)
<b>Mongolia</b>	43 (48)	--	--	1,428 (994)
<b>Nepal</b>	88 (93)	38 (23)	128	200 (156)
<b>Sri Lanka</b>	77 (78)	35 (28)	120	734 (642)
<b>Vietnam</b>	75 (81)	41 (26)	167	253 (-)

Source: World Bank, World Development Indicators 2003 (Tables 3.1, 3.2, 3.3, 3.3).

The lack of public investment in irrigation has impeded agricultural growth in many countries. In some countries, such as Cambodia and Indonesia, only a small share of cropland is irrigated. While some countries, such as Bangladesh and Vietnam, have dramatically expanded the share of irrigated cropland in the last twenty years, others, such as Cambodia, China, Indonesia and Sri Lanka, have made negligible progress or have experienced declines.

Not surprisingly, crop production has languished in many countries. The most notable exception is Vietnam, where crop production increased by about two-thirds in the decade between 1989-91 and 1999-2001 (Table 6). In Indonesia, Nepal and Sri Lanka, however, there has been little progress in this regard.

Despite agricultural growth in some countries, such as China, Vietnam and, to some extent, Bangladesh, labour productivity remains low. In Vietnam, for instance, agriculture value added per worker in 1999-2001 was only US\$ 253. China has more than doubled its labour productivity in the last twenty years but in 1999-2001 its value added per worker was still only US\$ 334.

These low productivity levels indicate that agriculture still retains considerable surplus labour, which nonfarm enterprises or urban manufacturing and services will have to absorb in the future. The lack of irrigated land and the slow growth of crop production in many of the countries studied also suggests that there remains a substantial need for increased public investment in rural areas in order to boost productivity and increase output. This is critical for improving the conditions of the large numbers of rural poor.

As already mentioned, the countries that have made the most progress against poverty have concentrated efforts on agricultural and rural development. For example, Vietnam, one of the countries with the strongest poverty reduction records, started economic reforms in agriculture through replacing collectivised farming with family-based farming. This was based on equitably distributing land use rights, according to family size and guaranteed for reasonably long periods. Systems of land-use rights have worked as powerful mechanisms to avert rural poverty in countries such as China and Vietnam.

China also boosted production incentives in agriculture, as state procurement at low prices was abolished and farmers were allowed to sell their marketable surplus to private traders. Controls on external trade were also relaxed and farmers helped produce an export boom in agricultural commodities, principally in rice but also in other commodities such as coffee, cashew nuts and marine products.

When economic reforms in China started in agriculture in 1979, the period of the most dramatic declines in poverty occurred—well before the country's National Poverty Alleviation Programme began. Poverty reduction was more rapid and comprehensive from 1979 to 1984 than in any period since then. The rate of poverty reduction began to slow thereafter, as the development strategy adopted an export orientation and shifted resources to the rich coastal regions. But during 1993-1996 poverty also dropped dramatically as real income per person rose 21 per cent in rural areas. The main

explanation is that in both 1979-1984 and 1993-96 the terms of trade of agriculture notably improved as farm purchase prices were raised, and farm incomes increased correspondingly.

The experiences of both China and Vietnam point clearly to at least one major successful strategy that many poor developing countries can adopt to achieve a rapid and pro-poor pattern of growth in the early stages of development.

**Table 7: Sectoral Rates of Growth**

<b>Countries</b>	<b>Average Annual Growth of GDP (%) 1990-2001</b>	<b>Average Annual Growth of Agriculture (%) 1990-2001</b>	<b>Average Annual Growth of Industry (%) 1990-2001</b>	<b>Average Annual Growth of Services (%) 1990-2001</b>
<b>Bangladesh</b>	4.9	3.1	7.2	4.6
<b>Cambodia</b>	5.0	1.8	10.2	6.2
<b>China</b>	10.0	4.0	13.1	8.9
<b>Indonesia</b>	3.8	1.9	4.8	3.6
<b>Mongolia</b>	1.2	3.2	-0.1	0.4
<b>Nepal</b>	4.9	2.6	6.9	6.2
<b>Sri Lanka</b>	5.0	1.7	6.5	5.7
<b>Vietnam</b>	7.7	4.2	11.6	7.3

Source: World Bank, World Development Indicators 2003, Table 4.1.

By contrast, the development experiences of Cambodia and Nepal show that the rate of poverty reduction will be slow if growth is not stimulated in agriculture. In both countries, a large majority of the poor are located in rural areas, with livelihoods tied directly to agriculture. During 1990-2001, the rate of growth of agricultural GDP was 1.8 per cent in Cambodia and 2.6 per cent in Nepal (Table 7). Growth in industry in both countries was faster but it was narrowly based—mostly in a small export sector producing garments and textiles.

Despite earlier successes in promoting agricultural growth, Indonesia also had a poor record, i.e., a 1.9 per cent rate of growth, during 1990-2001. This has hampered its

ability to make any dent in poverty. In Sri Lanka agricultural growth has been a mere 1.7 per cent and poverty has increased partly as a result.

In contrast, China had a 4.0 per cent rate of growth of agricultural GDP and Vietnam a 4.2 per cent rate of growth (Table 7). While industry in both countries grew much faster, it was increasing incomes in rural areas that explained most of their success in continuing to reduce poverty.

The Sri Lanka case study argues that although the growth rate of agriculture cannot be expected to match that of manufacturing, the promotion of domestically oriented agricultural food production is essential for the country's development prospects. Since food is a major component of urban wage costs, agricultural productivity is critical for the success of the country's industrialization. If Sri Lanka depends excessively on food imports, devaluating its currency in order to try to boost the competitiveness of its manufactured exports will backfire since it will raise the cost of food.

The Sri Lanka case study also debunks the Neo-Liberal assumption that complete privatisation and commercialisation of land is a foundation for agricultural development. This assumption is based on the notion that privately owned land is necessary as collateral to obtain credit. But the case study maintains that private ownership of land is most likely to lead to "fire sales" of the land of poor farmers. Instead of private ownership, the case study argues for clearly defined "land entitlements", such as 100-year land-use leases. Such a land tenure system should be complemented by the widespread provision of agricultural credit by state financial institutions.

## **5. Implementing Pro-Poor Financial Reforms**

In many of the countries studied, financial liberalization has been one of the most ineffective components of the Neo-Liberal reform agenda. While such liberalization had been heralded as an essential ingredient of pro-growth and pro-poor economic reforms, it appears to have contributed more to destabilizing economies and withdrawing financial services from the poor.

In Bangladesh, while financial liberalization had been designed to lower the real rate of interest, in practice it has led to a higher rate and a widening spread between the

deposit and lending rates of interest, hampering both the mobilization of loanable funds and the expansion of lending for private investment. In 2001 the real rate of interest was 14 per cent and the spread between deposit and lending rates was over 7 percentage points. In Cambodia the spread between the two rates was over 12 percentage points in 2001. The interest rate spread is a small but significant barometer of the failure of financial liberalization in these countries.

Another is the increasing inequality in the access to credit. In Cambodia the private banking system is highly concentrated and located mainly in the capital. While liberalization has helped stabilize the economy and led to financial deepening in urban areas, its benefits have largely bypassed rural areas. Whereas 90 per cent of all deposits and liabilities are dollar denominated, the great majority of low-income Cambodians, especially in rural areas, carry out transactions in riel, the domestic currency. Therefore, devaluation of the riel vis-à-vis the dollar widens inequality between rich and poor.

Banks are reluctant to lend in rural areas, where the economy remains relatively stagnant. This reluctance to lend, signalled by a large interest-rate spread, means that the banking system is building up excess reserves (reported to be roughly three per cent of GDP) and the economy is paying the price in terms of lost potential for growth.

For Cambodia, the UNDP-supported case study stresses the importance of creating an efficient and sustainable rural credit system. For most countries in Asia-Pacific, this is a major prerequisite for fostering pro-poor growth.

The impact of financial liberalization in Nepal has been similar to that in Cambodia. While financial liberalization has led to the spread of financial institutions and financial deepening (reflected in the increase of credit as a share of GDP to about 46 per cent in 2001), there has been no increase of credit to rural areas, where poverty is concentrated. The government has, in fact, withdrawn from rural development banks and phased out priority sector credit programs that benefited rural development. As a consequence, in rural areas, indebtedness is on the rise, in conjunction with growing landlessness.

Micro-finance has been growing in Nepal but is largely donor-driven and has a small capital base. While a valuable tool for stimulating self-employment, micro-finance cannot substitute for a viable rural banking system, which could provide adequate credit

to farmers and employment-generating small and medium non-farm enterprises. This is a major lesson drawn from across the case studies.

In China, in contrast to most of the other countries studied, there is indeed a rural banking system, comprised of the Agricultural Bank of China and the rural credit cooperatives. However, in the wake of liberalization, even these institutions have retrenched their operations, particularly in poor regions, and become more cautious in providing loans, demanding more collateral and guarantees. As the largest grass-roots source of official finance in rural areas, rural credit cooperatives need, however, to be expanded and strengthened.

In Sri Lanka, efforts to generate accelerated, pro-poor growth have been hampered because there has been no real source of medium-term or long-term finance for productive private investment since the privatisation of two state financial institutions, the Development Finance Corporation of Ceylon and the National Development Bank. The case study argues that contrary to the claims of the advocates of financial liberalization, private financial institutions provide relatively little long-term investment finance. Either retained earnings or state credit institutions usually provide such financing.

While Vietnam has moved to increasingly commercialise its banking system, it has retained some institutions to provide directed credit to priority industries and poor rural households through the Development Assistance Fund (DAF) and the Social Policy Bank. Backed in part by donor resources, the DAF was established in 2000 to provide subsidized state loans for medium or long-term investments in priority areas, such as infrastructure, export sectors or heavy industry. It is the largest Vietnamese financial institution that channels funds, both domestic and foreign, to investment. In 2002, DAF accounted for about one fourth of all domestic credit.

With branches in all provinces, the Social Policy Bank provides microfinance to agricultural households and low-income groups, mostly in rural areas. It also gives loans for micro-enterprises and small and medium enterprises. The Government of Vietnam uses both the Development Assistance Fund and Social Policy Bank for policy lending and keeps them separate from the commercial banking sector.

In the wake of its mini financial crisis of 1996-97, as well as the Asia Financial Crisis thereafter, Vietnam has tightened up regulation of the financial system. The crisis in 1996-97 arose because of very high domestic interest rates (vis-à-vis foreign interest rates) and the liberalization of foreign short-term borrowing (primarily through letters of credit). Guaranteed by state banks, external borrowing was channelled into the speculative real-estate market, causing a speculative bubble in the property market that ended up bursting in 1997.

Because of this experience, the central bank has put strict limits on providing loan guarantees for such short-term external borrowing and maintained capital controls on short-term capital flows, including those associated with trade credits. Like Vietnam, China has also used controls to protect itself against the volatility of external capital flows. However, such measures have not prevented these countries from enjoying a continuing inflow of foreign direct investment, which has been motivated principally by their record of rapid and sustainable growth.

There is no conclusive evidence that financial integration with the world economy will enhance a country's rate of economic growth (Prasad, Rogoff, Wei and Kose 2003). But there is evidence that capital account liberalization is associated with an intensification of some countries' vulnerability to crises. Thus, the Neo-Liberal consensus on such liberalization has shifted to a more cautious endorsement, and has tried to place the main blame for volatility on the lack of sound domestic institutions, not on the pro-cyclical nature of external capital flows.

Indonesia represents one of the worst-case scenarios for financial liberalization. Domestic de-regulation of its financial sector, beginning in the late 1980s, coupled with a completely open capital account threatened a financial meltdown during the Asia Financial Crisis. In response, the Government provided blanket guarantees to its foreign and domestic creditors for all deposits and debts.

The Government committed itself to the disastrous policy of massively bailing out its banking system by recapitalizing it with government bonds, on which it continues to pay interest and principal. This has drained public resources from vital economic and social services. As a consequence, Indonesia has found itself abruptly reclassified from a

rapidly developing “East Asia Miracle” economy into a seriously indebted low-income country.

Among the general lessons to be drawn from the UNDP-supported case studies are the need for the state to regulate the domestic financial sector, maintain some controls on short-term external capital flows and help build up domestic financial institutions, such as in rural areas, which can provide broad and equitable access to credit.

## **6. Generating Widespread Employment for Poverty Reduction**

While much of the rhetoric of the latest generation of national poverty reduction strategies, the PRSPs, supports the importance of pro-poor growth, most of them overlook a critical set of public policies that can help achieve such an objective, namely, feasible policies to generate widespread employment at decent wages. In Asia-Pacific, this has had a lot to do with the lack of development of agriculture and non-farm rural enterprises. It also relates to the lack of development of small and medium enterprises generally and the failure to move labour out of agriculture and into higher-productivity industry.

In half of the countries studied by the regional programme, Bangladesh, Cambodia, Nepal and Vietnam, the majority of the employed are in agriculture (Table 8). In Nepal those employed in agriculture account for over three-quarters of all employed and in Cambodia almost three-quarters. The share of the employed in manufacturing is relatively small in most of these countries. Sri Lanka has the largest share, i.e., about 17 per cent while Nepal has the smallest, i.e., about 6 per cent. Outside agriculture, there are few opportunities for employment except in services, most of which are low paying.

Generating widespread employment depends principally on the character of growth—namely, whether it is reaching the sectors and regions where the poor are concentrated and employing the factors of production that they possess. Generally, this implies that growth should have an employment-intensive character. But this is obviously not enough since the most labour-intensive sectors are often the lowest paying.

Another essential condition is to raise the income of the poor through boosting their productivity—either by raising it in sectors, such as agriculture, where the poor are located or moving them to higher-productivity sectors, such as manufacturing. Thus, as a

complement to macroeconomic and adjustment policies, sectoral public policies have a role to play in allocating resources to certain sectors, such as agriculture, in order to increase their productivity and growth.

**Table 8: Employment**

<b>Countries</b>	<b>The Share of the Employed in Agriculture 2000</b>	<b>The Share of the Employed in Manufacturing 2000</b>
<b>Bangladesh</b>	62.3	7.4
<b>Cambodia</b>	73.7	7.0
<b>China</b>	46.3	12.4
<b>Indonesia</b>	45.3	13.0
<b>Mongolia</b>	48.6	11.2
<b>Nepal</b>	76.1	5.8
<b>Sri Lanka</b>	36.0	16.6
<b>Vietnam</b>	69.1	9.6

Source: Asian Development Bank 2002.

The experience of Bangladesh is illustrative in this regard. In the 1990s, it was able to accelerate the rate of poverty reduction: the proportion of the population in poverty dropped from 50 per cent in 1991/92 to about 40 per cent in 2000—a significant improvement over very slow progress in earlier decades. This was largely due to employment generation in the non-tradable sectors—mainly construction, small-scale industry and services—not the tradable sectors. A boom in crop production in the late 1980s shifted agricultural labour into non-farm employment in these sectors.

Whereas in the early 1980s landlessness had forced farmers into poorly paid self-employment in the non-farm sector, by the 1990s increased agricultural prosperity served as the foundation for the growth of larger-scale non-farm enterprises that provided higher-paying wage employment. Thus, the quality of employment had improved significantly as well as the quantity.

In Sri Lanka while GDP was increasing by 4.8 per cent from 1990 to 2001, employment increased by only 2.3 per cent (Seth and Deb 2003). The slow growth of employment was due to the shedding of labour in agriculture and the inability of industry

and services to fully compensate for this loss. About half of this labour was absorbed by low value added manufacturing and services. Within manufacturing much of this displaced labour took up work in the informal sector, in sub-contracting and casual jobs. The “level-playing-field” policies of trade liberalization had undercut much of the dynamism of the industrial sector and its ability to increase remunerative employment.

Early in China’s transition, it had remarkable success in generating rural employment. In the early 1980s, the economic reforms in agricultural institutions and incentives led to a boom in rural prosperity, which sparked the rise of non-farm Township and Village Enterprises, which absorbed a significant share of surplus agricultural labour. But later in the transition, the early successes in employment generation began to give way to stagnation.

Since 1995, state owned enterprises (SOEs) have been laying off workers. As a result, their share of total urban employment dropped from 83 per cent in 1990 to 35 per cent in 2000. Domestic private enterprises have been net providers of jobs but not at a rate fast enough to absorb the workers rendered redundant by SOE restructuring. These private enterprises accounted for only 16 per cent of total urban employment in 2000. As a result of the slowdown in job creation, urban unemployment stood at 13 per cent in 2000.

The case study maintains that it is imperative for policymakers in China to develop a strategy to support development of domestic private enterprises, mainly more labour-intensive small and medium enterprises and particularly in the underdeveloped service sector. Without a quantum jump in job creation, the surplus labour in agriculture that is likely to be displaced by WTO-guided trade liberalization will have no place to go for decent work.

In Indonesia, faster and more employment-intensive growth will depend on fostering agricultural development and more rapid growth of small and medium enterprises (SMEs). Stimulating agricultural prosperity will, in fact, help promote the development of small and medium enterprises in rural areas, most likely concentrated in agro-industry, which can supply inputs to agriculture or process its commodities.

The case study contends that for general SME development, the government needs a comprehensive and integrated programme. There is a myriad of small enterprises

in Indonesia, many in the informal sector, but few can obtain the access to resources and business services to graduate into medium-sized enterprises that can provide Indonesian workers with decent work, i.e., work based on skills and paying a poverty-eliminating level of wages. Self-employment and micro-enterprise development, albeit employment-intensive, are not the solution to widespread poverty. Hence, public policy needs to concentrate on small enterprises and enable them to grow into medium-sized enterprises.

Adopting a “shock-therapy” strategy, Mongolia has suffered a severe process of de-industrialization during its transition to a more market-based economy. The share of industry in GDP dropped from 30 per cent in 1990 to 17 per cent in 2001. The unemployment rate still stood at 17.5 per cent in 2000 as economic growth ground to a virtual standstill. Agriculture (mostly herding) still accounted for about half of the labour force.

In response, the UNDP-supported case study calls for a diversified array of policies that accord a higher priority to generating a more employment-intensive pattern of growth, including the promotion of small and medium sized enterprises in agriculture and manufacturing, establishment of decentralized incubation centres for micro-enterprises and expansion of the public works programme (which have been a successful component of the country’s National Poverty Alleviation Programme).

## **7. Implementing a Pro-Poor Trade Strategy**

In the countries covered by the Asia-Pacific regional programme, the impact of trade liberalization on poverty has been mixed. Generally, the studies recommend that such liberalization should be approached cautiously, with some protection of domestic industry being combined with export promotion. Also, several of the studies urge that trade policies be linked with a pro-active industrial strategy in order to maximize the benefits for development.

In some countries, such as Vietnam, a process of liberalizing trade has contributed initially to an export boom, which has imparted benefits across the economy, including the farming sector. But liberalization has also been accompanied in many of these countries by a surge in imports, so that trade deficits remain large (Table 9). For example, in Mongolia—a small economy that strove to open up rapidly—the share of exports shot

up from 24 per cent in 1990 to 64 per cent in 2001 but imports rose from 53 to 80 per cent in the same period.

Simultaneously with export promotion, Vietnam has pursued a policy of fostering domestic substitutes for imports and thus its trade account remains roughly in balance. China and Indonesia are running trade surpluses (the latter in order to pay off a large external debt) but the rest, like Mongolia, are running substantial trade deficits. With the slowdown in the global economy, even successful countries such as China and Vietnam face the prospect that their exports will no longer be able to function as the engine of growth for their economy.

In many of the countries studied by the regional programme, the reputed benefits of trade liberalization have not reached the poor, especially those in rural areas. While there is some evidence that export promotion initially benefited farmers in Vietnam, for example, the impact was most pronounced in the more developed rural regions, which produced most of the exportable commodities.

In general, the benefits of trade liberalization have been unequally distributed. Therefore, the case studies call for pro-poor interventions that can compensate, at least, for the adverse effects of liberalization. These could run the gamut from the less controversial, such as improved social security (as advocated by the China case study), to the conventional responses, such as the provision of public goods and agricultural development, to the most controversial, industrial policies (as advocated by the Indonesia case study).

Part of the explanation for the unequal distribution of the benefits of trade is the lack of a supply response from poorer farmers and small enterprises when increased trade has broadened economic opportunities. This is a particular problem in rural areas, where there is a lack of infrastructure, credit, marketing channels and public services. Poverty reduction strategies should be geared to address these shortcomings.

Another part of the problem is the unequal distribution of benefits across countries. Some countries remain wary of completely opening up their economies because of the potentially devastating effects on their industrial and agricultural sectors, especially if industrial-country markets for exports of agricultural commodities and labour-intensive manufactures from developing countries remain protected.

Some countries, such as Cambodia, Mongolia and Nepal, have banked heavily on garment and textile exports but international competition is intense in these subsectors and foreign direct investment is footloose. The Sri Lanka case study warns that too many developing countries are specializing in the same low-value-added products such as garments and have not diversified their manufactured exports. Instead, they should be concentrating on relatively income elastic and price inelastic export products.

In several of the countries studied, trade liberalization is only partial. For example, in 2000, the weighted mean tariff on all products was 21 per cent in Bangladesh and about 17 per cent in Nepal (Table 9). Other countries, such as Indonesia, have gone much further with liberalization. For example, the weighted mean tariff on all of Indonesia's products is only 5.4 per cent and its international trade taxes are only three per cent of all revenue (Table 9). But this has restricted its options for financing public investment that can stimulate a higher rate of growth. Similarly, Mongolia's financial options are constricted because international trade taxes in Mongolia account for only seven per cent of all revenue.

**Table 9: Trade Performance**

<b>Countries</b>	<b>Exports of Goods and Services as % of GDP 2001 (1990)</b>	<b>Imports of Goods and Services as % of GDP 2001 (1990)</b>	<b>International Trade Taxes as % of Total Current Revenue 2000</b>	<b>Weighted Mean Tariff on all Products (%) 2000</b>
<b>Bangladesh</b>	15 (6)	22 (14)	23	21.0
<b>Cambodia</b>	53 (6)	61 (13)	--	--
<b>China</b>	26 (18)	23 (14)	10	14.3
<b>Indonesia</b>	41 (25)	33 (24)	3	5.4
<b>Mongolia</b>	64 (24)	80 (53)	7	--
<b>Nepal</b>	22 (11)	32 (21)	27	16.8
<b>Sri Lanka</b>	37 (29)	44 (38)	11	7.2
<b>Vietnam</b>	55 (36)	57 (45)	15	15.1

Source: World Bank, World Development Indicators 2003 (Tables 4.9, 4.9, 4.13, 6.6)

Also, Sri Lanka has reduced its weighted mean tariffs to about seven per cent and its international trade taxes account for only 11 per cent of all revenue. The case study argues that Sri Lanka should base its development strategy on concentrating on a

diversified range of manufactured exports. But it also recommends that some support be given to import substituting manufacturing activities. This would include promoting import substitution for food processing since food is such a crucial component of household expenditures, particularly poor households.

The Indonesia case study contends that national policymakers should take a more critical approach to trade liberalization. Although Indonesia has lowered its wage costs through devaluation since the Asia Financial Crisis, it has not managed to boost its labour productivity enough to contend with new competitors, such as China, in Indonesia's traditional stronghold of exports of labour-intensive manufactures. Thus, it needs a more pro-active industrial policy that can enhance the competitiveness of such sectors.

Indonesia also needs to reform its system of tariffs and quotas to provide more effective medium-term protection to rice producers, who are under intense competition from regional exporters of cheaper rice. Thus, full liberalization of rice production, the case study argues, would court social disaster.

As countries that have been successful with an export orientation, such as China and Vietnam, join the WTO and continue to open up their economies, their development options could also become much more constricted. For example, the weighted mean tariffs on all products in 2000 continued to be about 14 per cent and 15 per cent in China and Vietnam respectively. Their accession to the WTO will lead to lower tariffs and thus more intense international competition.

The assumption of some of the case studies appears to be that agriculture, especially the food crops subsector, is likely to be hard hit by liberalization while labour-intensive activities, such as those producing manufactured exports, or even cash crops in some instances, should be able to prosper. The poverty consequences of these predicted changes will depend, of course, on the weight of these various sectors. However, some of the case studies, such as Vietnam's, call into question the assumptions underlying such projections, which are based on unrealistic conditions.

In Nepal trade liberalization has benefited only a small formal sector. Exports are narrowly concentrated in garments, carpets and pashmina and have not increased as fast as the flood of imports. As a result, the trade deficit has risen to 20 per cent of GDP. Whatever income has been generated is becoming more concentrated in the urban

industrial and commercial sectors. Meanwhile, farmers are facing stiff competition from cheap imports of rice. The supply response in agriculture has been weak because of the low level of productivity and commercialisation of the sector.

The UNDP-supported case study therefore calls for the Government in Nepal to focus its interventions on building up the supply response of agriculture and implementing an industrial policy that directs public investment to broaden the export base of the country and reduce its heavy dependence on imports.

The effects of trade liberalization in Cambodia have been similar to those in Nepal. Cambodia is a small open, dollarized economy, heavily dependent on imports. Its garment sector, mainly foreign owned, accounts for most exports. But only a minority share of the value added in this sector remains in the country, partly because of its high import content. Trade liberalization has led to more foreign investment in urban enclaves but it has done little so far to benefit agriculture. In order for the rural population to benefit from trade-related activities, the state will have to help develop local markets, human capital and infrastructure.

China faces new poverty challenges as a consequence of its accession to the WTO in 2001. The case study expects that the gains from trade will be unevenly distributed across sectors and provinces. The distribution of income is likely to become more unequal as the rural-urban income disparity worsens and the income gap between coastal and interior regions widens.

The rural population in China faces a major challenge as the domestic price of agricultural products will decline and agricultural labour will have to be absorbed elsewhere in the economy—or find employment producing more labour-intensive crops, such as vegetables and fruits.

While the domestic vehicle industry is bound to suffer from increased liberalization, the case study expects China to continue benefiting from the export of labour-intensive items such as textiles and clothing. However, one of the dangers of liberalization is that a country will be relegated to a low rung of the technology ladder, and be unable to develop a dynamic comparative advantage in more skill- or capital-intensive exports.

The study recommends that China's trade policies should be carefully calibrated. It argues that trade liberalization has to be a two-way street between developing countries and industrial countries. Based on projections on the differential impacts of liberalization, the case study recommends that China open up its agricultural market to imports only in conjunction with the opening up of industrial-country markets for its labour-intensive exports. The study also recommends that China take advantage of WTO rules to raise its subsidy levels and provide other acceptable forms of support, such as safety net programmes or food aid, to sectors such as agriculture that are most likely to suffer from liberalization.

### **Concluding Remarks**

This paper has presented some preliminary policy recommendations from eight case studies of the Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction. As the studies are finalized and thematic summaries are completed, these preliminary recommendations will, no doubt, be refined and elaborated. Nonetheless, these initial conclusions chart out elements of a macroeconomic framework that is distinctly different from the Neo-Liberal policy matrix that has dominated economic prescriptions for the last two decades.

These elements include a more pro-active fiscal stance, focused on public investment as basis not only to foster more rapid growth but also as a mechanism to focus resources on poverty. In this framework, monetary policies play a complementary accommodating role to expansionary fiscal policies and eschew restrictive inflation targeting. In order to finance additional public investment, a more concerted effort would need to be mounted to mobilize domestic public resources, which are deemed to be too low in many countries to support a pro-poor growth strategy.

Also included in the macroeconomic framework are recommendations for stronger regulation of financial institutions and external short-term capital flows and the use of state financial institutions to direct credit for both growth-promoting and poverty-reducing purposes. There is also a cautious policy stance towards trade liberalization, with a preference for backing trade policies with pro-active industrial policies, allowing medium-term protection of vital domestic sectors and focusing development on sectors,

such as agriculture, where poor workers are concentrated and are likely to suffer from unbridled liberalization.

In order to heighten the pro-poor impact of growth, this alternative policy stance also places priority on some sectoral measures, such as employment generation and agricultural and rural development, as critical complements to macroeconomic and adjustment policies. For job creation, the emphasis is on not only fostering a more employment-intensive pattern of growth but also taking explicit public measures to boost the productivity of poor workers. For agricultural and rural development, the emphasis is on deploying public investment for critical public goods (such as rural roads and irrigation), improving agricultural terms of trade and providing equitable and sustainable access to productive resources, such as through secure use-rights to land.

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