

Fostering Inclusive “Growth+” for the Poorest

This part of the book focuses on economic growth, in particular on policies that create an environment that enables income growth for the poorest—that is, “growth+.” The ultra poor face new challenges—including economic recession and volatility—that affect strategies to enhance their assets and income. Global macroeconomic trends affect poor countries’ ability to facilitate pro-poor growth and even growth in general. Furthermore, poor countries, which are for the most part agricultural societies, face the additional constraint that agricultural growth takes place in the context of increasingly globalized agricultural value chains. Nevertheless, there is much that national governments can do to promote pro-poor growth. To that end, when they consider how to engender this type of growth, countries need to account for the potential trade-offs between economic growth and increasing inequality, particularly in the short to medium run.

The chapters and the essay in this part of the book address these issues in more detail. The first two chapters look at some of the exogenous factors that affect the growth and development strategies available to developing countries, and the next five look more closely at what is meant by pro-poor growth and at the inherent trade-offs that policymakers must consider in their strategies. The final five chapters focus on specific policies—aspects of labor markets, fiscal policies, and a framework for property rights—that are important components of creating an environment that facilitates income growth for the poorest.

Global Factors Affecting Growth

In Chapter 9 Eugenio Díaz-Bonilla underscores the importance of the international economic environment for growth in developing countries. By exploring the global cycles of growth and downturns since the 1960s, the author demonstrates how many global variables—such as growth rates in developed countries, levels and terms of global trade, global trends in inflation, interest rates, exchange rates, capital flows, export subsidies in developed countries, and commodity prices—affect growth rates and thus the opportunities available to the poorest in developing countries. In so

doing, Díaz-Bonilla stresses the need for developing-country governments to design policies that smooth the global business cycle.

Given that agriculture plays such a central role in many developing countries and in the livelihoods of the very poorest (a point discussed further later in this introduction), policymakers must think about how in-country agricultural growth interacts with the global economic environment. In Chapter 10, Joachim von Braun and Tewodaj Mengistu argue that globalization in the agricultural food system has altered the appropriate strategy set available to developing-country governments. They point out that globalization offers opportunities for growth and opportunities for poor people through direct or indirect access to previously unavailable assets and markets, but with these new opportunities come new risks that need to be mitigated and managed. The authors then outline some policy suggestions that would allow countries to take advantage of the opportunities presented by increased globalization while minimizing the associated risks.

Pro-Poor Growth and Inherent Trade-offs

A fundamental debate is taking place about whether all growth should be fostered because all growth will be good for the poor (Dollar and Kraay 2002) or whether countries should try to encourage growth that reduces inequality by preferentially increasing the incomes of the poor (Besley and Burgess 2003; Bourguignon 2003). In other words, do countries need to worry about inequality when facilitating poverty-reducing growth? Martin Ravallion discusses this issue in Chapter 11 by examining the relationship among inequality, growth, and poverty. He argues that although growth is pro-poor on average (Dollar and Kraay 2002), distributional issues are nonetheless important in determining how economic growth affects poor people. Inequality is of concern because growth tends to be less pro-poor in more unequal countries. Poverty also tends to be less responsive to growth in very poor countries, and the combination of high levels of both poverty and inequality greatly reduces the responsiveness of poverty to growth. In fact, countries with high levels of inequality and poverty will require twice the rate of growth to secure the same amount of poverty reduction as countries with average levels of inequality and poverty.

When inequality in a society is inherited rather than the result of the differential impact of skills and asset acquisition, inequality is much more likely to limit the effects of growth in the long run. Ravallion refers to these inherited inequalities as “bad inequalities.” They could include limited property rights for land acquisition or identity-based exclusion from education and markets. Some researchers have observed that income inequality is anti-growth in developing countries but pro-growth in developed countries and have argued that this outcome occurs because

asset inequality causes a larger share of income inequality in developing countries (Lipton and Ravallion 1995; Barro 2000). The importance of land reform and property rights is addressed later in this part of the book. Exclusion on the basis of identity is considered in Part 4.

Ravallion also argues that the impact of growth on poverty depends on whether inequality is increasing at the same time as growth, and this factor in turn depends on whether regional and sectoral growth occurs in those sectors where the poor are located.

In looking at the experience of Latin America in the 1980s and 1990s, Alberto Valdés and William Foster (Chapter 12) argue that all growth helps alleviate poverty—even if it is growth that is not particularly pro-poor. They note, however, that growth would ideally also reduce inequality. They then tackle the difficult question of the trade-off between policies that affect distributional measures and poverty in the short term and policies that foster growth and poverty alleviation in the long term. They identify some policies that may facilitate growth but not particularly growth for the poor—financial deepening, trade liberalization (although see Chapter 28 for a counterexample), and limitations on the size of government. They point to other policy actions that facilitate growth that is good for the poor—that is, policies that facilitate both growth and improvements in the income distribution. These policy actions include investments in infrastructure, conditional cash transfers that improve the health and education of poor households, and reductions in anti-export biases that increase demand for unskilled labor. Valdés and Foster underline that improving the productivity of unskilled labor is nearly always an essential part of a growth strategy that particularly benefits the poorest. Even more generally, a growth strategy that benefits the poorest is one that increases the returns to their assets, namely unskilled labor and, in Africa, land.

Stephan Klasen further delineates the policies that promote pro-poor growth in Chapter 13. In the past few years much analysis has been devoted to how to encourage growth that benefits the poor. Two edited volumes bring together different countries’ experiences in fostering pro-poor growth (Besley and Cord 2007; Grimm, Klasen, and McKay 2007). These books and the report by the Commission on Growth and Development (2008) provide some cross-country lessons on how to foster growth in the regions and sectors where the poorest are located (or to which they are likely to move). Klasen discusses some of the insights of this research in his chapter and notes the importance of productivity improvements in the food crop sector through better seeds and inputs; improved rural infrastructure and improved access to credit; greater growth in lagging regions through means such as infrastructure, investment, and fiscal policies that target these regions; increased education and better land access programs to improve the asset base of the poor; and investments in education and employment for women and disadvantaged groups.

Klasen's chapter provides a thorough review of growth that benefits the poor, but the focus is not explicitly on growth that benefits the poorest. Many growth-related policies, however, are immediately transferable to those who have few assets and are located in marginal and remote regions. In particular, of immediate relevance are policies that focus on improving the poorest people's access to land (land reform will be discussed further later), improving the returns to marginal land (through investing in seed technologies for marginal lands and infrastructure for remote areas), and encouraging employment for women and disadvantaged groups. The development community also needs to undertake additional research to better understand what policies reduce the severity of poverty, not just the number of people counted as poor.

In many countries the poorest are located in rural areas and have livelihoods based in the agricultural sector. Therefore, identifying policies that promote agricultural and rural development can be important in creating an environment in which the poorest can realize growth in their incomes (Mellor 1995; Fan and Zhang 2008). In Chapter 14 Jikun Huang, Qi Zhang, and Scott Rozelle illustrate how China, the country that has made the greatest strides in both growth and poverty reduction in the past three decades, has gone about achieving sustained economic growth accompanied by substantial poverty reduction. They argue convincingly that this success is due to the focus on agricultural growth. The lesson for other countries is that growth in the agricultural sector can be important in meeting the needs of the poorest. The role that agricultural growth will play, however, is not constant across countries. It will vary with the characteristics of a country's labor and land markets and the degree to which a country can import and export agricultural commodities (Dercon 2009). Additionally, the nature of agricultural growth will determine whether it results in sustained improvement in the well-being of the poorest. Agricultural growth that arises as a result of technological advances that raise the productivity of labor and that is complemented by growth in demand for unskilled labor will benefit the poorest the most (Lipton 2005).

Although Chapters 11–14 emphasize the need for policies that encourage income growth among the poorest, in Essay 1 Nancy Birdsall provides a point of contrast to the emphasis of this book on the poorest. She argues that fostering growth for the middle class—what she terms “inclusive growth”—rather than the poorest should be the priority. She writes that such growth is important because it both proves sustainable in the long run (given that it benefits a large part of the population) and usually reflects growth that is based on employment creation and improved returns to assets. She thus suggests that taking these long-term considerations into account, governments should pursue not necessarily sectoral growth where the poorest are located but rather growth in sectors where the majority of the population is located. Although the other chapters in this section would agree that

focusing on employment creation and the long-term quality of growth is important, ideally this approach should be combined with a focus on growth in assets and incomes for the poorest. As argued in Chapter 1, Chapter 11, and many of the other chapters in this volume, asset inequality that leaves the poorest without land and education retards growth.

Specific Policies to Promote Pro-Poor Growth

The final five chapters in this part of the book focus on specific national policies required to create an environment in which the ultra poor can realize welfare improvements. Developing labor markets that facilitate the movement of unskilled labor between sectors is an important part of ensuring that the poorest realize the highest possible returns to this asset. Chapter 15 considers one aspect of policy that can help in this regard by examining policies that facilitate migration. Chapters 16 and 17 consider policies for a national framework for land rights, another asset important to the poorest. Chapters 18 and 19 focus on the fiscal framework required for reducing ultra poverty.

In many countries inclusive growth means growth that includes poor households living in regions of the country that are lagging behind others (Kanbur and Venables 2005). Given that many of the ultra poor live in rural areas and areas that are far from active markets and effective public services, one key question for policymakers is whether it is better to encourage growth in those areas or to enable people in those areas to migrate elsewhere if they choose. Some empirical evidence shows that investments in some lagging regions can bring higher returns—in terms of both reduced poverty and greater gross domestic product—than elsewhere (Fan, Hazell, and Thorat 2000). In these cases investments in lagging regions would be the appropriate policy response. In other cases, fostering internal migration may be part of the solution for poverty reduction.

In Chapter 15 Alan de Brauw focuses on international migration but also discusses how migration of any type, including rural–urban migration, can directly and indirectly benefit the poorest. He argues that although increased emigration from developing countries, particularly in the form of loss of skilled labor, has known drawbacks, it can also offer real benefits to poor and vulnerable households. International migration is not really a possibility for the poorest, but they may benefit from it through increased remittance receipts that improve their incomes and living standards, as well as through new labor market opportunities and increases in wages for those who stay behind. Furthermore, de Brauw considers what types of policies would foster positive outcomes from increased international migration, which are also transferable to the context of internal migration. He suggests policies that reduce the costs of moving, searching for a new job, and sending money to

family members left behind and policies to allow safety net benefits to be transferred to other family members.

As highlighted in Chapter 1, ensuring stability by ending and preventing conflicts is a fundamental prerequisite to any strategy aiming to achieve pro-poor growth. Although the causes of conflict are multiple and require action on many fronts (see, for example, Collier 2007), in Chapter 16 Gunnar Sørbo and Arne Strand emphasize the importance of land disputes in driving and sustaining protracted conflict and poverty, using examples from two of the world's poorest and most conflict-ridden countries, Afghanistan and Sudan. They underscore the need to address issues of land ownership, agricultural production, and rural employment in building sustained peace in Afghanistan and the importance of a framework to deal with the alienation of land that has driven the marginalization of certain groups.

The relationship between limited land rights and ultra poverty is also present in more peaceful societies. Chapter 6 showed that landlessness is a characteristic of the ultra poor (particularly in South Asia), and a number of studies have highlighted the causal relationship between lack of productive land and poverty (for example, Deininger 1999 and World Bank 2003). Providing a national framework for access to and ownership and transfer of land is thus often an important part of addressing ultra poverty. Ruth Meinzen-Dick, Patricia Kameri-Mbote, and Helen Markelova take up this issue in Chapter 17. This chapter describes challenges involved in strengthening the property rights of the poorest people and identifies potential policies for overcoming these challenges. The chapter notes that although redistributive land policies have enabled millions of people to gain access to land, the poorest have not always benefited. For redistribution of land to benefit the poorest, it is important to include local participation in identifying the poorest, to allow women to be included on land titles, and to carefully examine prior land uses to ensure that redistribution does not take land away from existing uses on which the poorest depend.

Chapters 18 and 19 particularly focus on the fiscal and management aspects of targeted and more general poverty reduction programs. Transfer programs can have a large impact on poverty reduction, as can the tax structures that support them. A regressive tax system based on indirect taxes will rely proportionately much more on the poor by increasing the cost of basic food items, basic services, and the like—items on which the poor spend a larger share of their income than do others. In Chapter 18 Ehtisham Ahmad considers fiscal policy instruments to generate revenue for such programs, as well as resource allocation strategies. He contrasts the more centralized approach of Mexico with the more decentralized approach used in China and notes that both countries have had successful programs but that the strategies of each have pros and cons. A program that mixes both elements may be more effective. Chapter 29 in Part 3 details Brazil's experience with a cash transfer program, Bolsa Família, and provides an example of how local knowledge can be

effective in targeting the poorest. Although Bolsa Família is centralized at the federal level, it relies on local governments for targeting and thus applies local involvement exactly in the way suggested by Ahmad’s chapter.

In Chapter 19, Chu Liming, Wen Qiuliang, Lin Zechang, and Fang Yaming provide more details on the mechanisms and policies for fiscal poverty alleviation used in China (policies that were also referred to in Chapters 14 and 18). They outline four types of instruments—poverty alleviation funds targeted to poor people, direct financial transfers to poverty-stricken areas, preferential policies and tax relief for economic development in poverty-stricken areas, and interest subsidies for poverty alleviation and development loans. For each of these instruments they highlight some of the specific challenges experienced by policymakers in its implementation. The authors then suggest future directions for such programs in China.

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Global Macroeconomic Developments: The Implications for Poverty

Eugenio Díaz-Bonilla

This chapter presents an overview of global macroeconomic developments over time and some of their implications for poverty trends in developing countries. It concludes with comments on possible macroeconomic policies to create a global environment for sustainable poverty reduction in developing countries.

Growth, Prices, and Capital Flows

Growth

A high level of stable growth is important for poverty alleviation. In general, analyses of the links between growth and poverty have focused on the implications of domestic growth, not world growth. However, there is an important amount of co-movement between world growth, led by industrialized countries (which still represent about 75 percent of world gross domestic product at market rates), and the economic performance of developing countries. Therefore, it is important to understand the trends and cycles in the world economy when discussing the evolution of poverty in developing countries.

Although world economic growth declined during every decade from the 1960s through the 1990s, it picked up somewhat in the 2000s until 2007. During this most recent period, annual growth in world gross domestic product (GDP) per

A more detailed discussion of these topics can be found in E. Díaz-Bonilla, *Global macroeconomic developments and poverty*, IFPRI Discussion Paper 00766, Washington, DC: International Food Policy Research Institute, 2008, <<http://www.ifpri.org/pubs/dp/ifpridp00766.pdf>>.

capita increased above its levels of the 1980s and 1990s, mainly because population growth declined. The performance of per capita GDP in developing countries strengthened, reaching its highest average annual rate (3.9 percent) in the past half century (Table 9.1).

Growth stability is also central to improving poverty trends. Overall, the global economy has gone through four cycles of strong deceleration in growth: 1974–75, 1980–83, 1991–93, and 2001–02. As of this writing in the late 2000s, the world has entered a fifth period of economic decline, which looks to be worse than the previous four cycles (Figure 9.1).

In each of the previous four global downturns, the number of developing countries in recession increased significantly; in some cases more than 50 percent

Table 9.1 World macroeconomic indicators, 1960s–2000s

Indicator	1960s	1970s	1980s	1990s	2000s
World					
GDP growth (% per year)	5.4	4.0	3.0	2.7	3.0
Per capita GDP growth (% per year)	3.4	2.1	1.3	1.2	1.7
Trade growth (% per year)	7.6	6.4	4.7	6.2	6.7
Trade as a share of GDP (%)	24.5	32.2	37.6	41.3	48.6
Developing countries					
Total growth (% per year)	4.9	5.3	3.4	3.4	5.2
Per capita growth (% per year)	2.7	3.1	1.4	1.8	3.9
Share in recession (%)	28.5	29.0	40.6	35.8	18.9
Capital inflows (% GDP)	n.a.	1.25	1.06	1.44	1.11
Consumption volatility	0.91	0.78	1.03	0.80	0.64
Inflation (% per year) ^a					
Industrialized countries ^b	4.9	8.7	6.2	2.8	2.0
Developing countries	4.9	16.2	36.7	36.1	5.8
Interest rates (%)					
Nominal ^c	6.0	8.4	10.6	5.5	3.2
Real ^d	1.0	-0.3	4.1	2.7	1.1

Sources: World Bank, *World development indicators* (Washington, DC: World Bank, various years); International Monetary Fund, *International financial statistics* (Washington, DC: International Monetary Fund, various years).

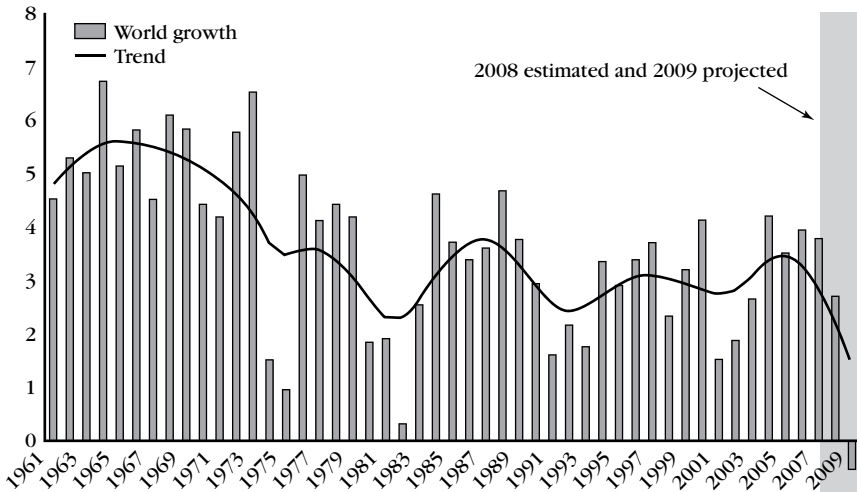
Notes: Growth is aggregated at market exchange rates. Consumption volatility data represent the median of a five-year rolling average of standard deviation / average growth for developing countries. For the 1960s, the data cover various years. For the 2000s, the data on GDP, trade growth, interest rates, and inflation are for 2000–06. n.a., not available.

^aConsumption index.

^bIndustrialized countries or advanced economies are a total of 33 countries, including the United States, the Euro area, Japan, the United Kingdom, and Canada; developing economies / countries include the 139 countries that are not classified as advanced economies. International Monetary Fund, *World economic outlook 2009* (Washington, DC: International Monetary Fund, 2009).

^cLondon Interbank offered rate for dollar deposits for six months.

^dUses industrialized-country inflation rates.

Figure 9.1 World growth and trend, 1960–2009

Sources: World Bank, *World development indicators* (Washington, DC: World Bank, 1960–2009); International Monetary Fund, *World economic outlook database*, World Bank, Washington, DC, 2009.

of developing countries were affected—55 percent in 1982 and 53 percent in 1992 (influenced by the breakdown of the Soviet Union). Average annual declines during the recession were -6.7 percent in the first year and -8.6 percent in the second. Based on the averages for each decade, volatility and the number of countries in recession increased during the 1980s and declined in the following decades, reaching their lowest values in the early to mid-2000s (see Table 9.1). In general, the numbers show that in the current decade and until recently, developing countries have enjoyed relatively high rates of growth with low volatility, which helped with poverty alleviation efforts. The current global economic crisis, however, will negatively affect both growth and poverty in developing countries.

Inflation and Interest Rates

Interest rates and inflation have important implications for growth and poverty alleviation. For instance, episodes of hyperinflation, such as those that occurred in several countries of Latin America and the Caribbean in the 1980s and 1990s, were accompanied by sharp increases in poverty. On the other hand, lower inflation, other things being equal, tends to alleviate poverty because the poor have nominal incomes that adjust slowly to change, and they do not have access to financial instruments that protect them from price increases. In recent decades, the world economy has gone through cycles of rising and falling inflation, with parallel up and

down cycles of nominal and real interest rates. The trend toward lower inflation and interest rates that started in the mid-1980s should have contributed to alleviating poverty until the mid-2000s.

During the early 2000s, U.S. monetary policy was still strongly expansionary (leading to negative short-term rates during that period), but that policy stance was reversed in 2004: then real short-term interest rates increased again to about 2 percent in real terms, and the real U.S. prime rate jumped to about 4 percent. This tightening of monetary policy and monetary conditions affected the housing sector in the United States and started the financial crisis that is still at the heart of the current U.S. and global recession. Clear signs of financial distress in mid-2007 led the U.S. Federal Reserve to again sharply reverse monetary policy and move toward a strongly expansionary stance. This monetary easing has influenced the large increases in commodity prices since the second half of 2007.

Commodity Prices

Many of the poorest developing countries and several of the middle-income ones depend on exports of a relatively small number of commodities. In particular, prices for commodities such as food and fuel have important implications for inflation and the value of the consumption basket that defines the poverty line. Therefore, price developments in these products tend to have a large impact on production, incomes, employment, fiscal accounts, and poverty in those countries. World commodity prices have experienced important changes in real terms over recent decades (Table 9.2).

During the 1960s and 1970s, the prices of many commodities (particularly food, beverages, and metals) were high in real terms. Oil prices jumped significantly during the mid- to late 1970s. In the early 1980s, the world macroeconomic environment changed markedly, leading to a sharp decline in world growth. Nominal and real prices of commodities declined, and during the 1990s real prices of most primary products were about half the levels reached in previous peaks. Real prices of most commodities (except agricultural raw materials) remained on a lower plateau for much of the 1990s.

After the deceleration of the early 2000s ended, the world resumed growth and commodity prices recovered from their previous lows. In the case of agricultural products, besides the resumption of world growth and greater demand from developing countries in the first half of the 2000s, rising prices have also been influenced by competition with crops oriented to energy use (which are subsidized in the main industrial countries) and adverse weather patterns.

The largest price increases took place for metals and oil, which in the second half of the 2000s surpassed the peaks achieved in the 1970s (in real terms). For agricultural goods, however, the story has been different. Although nominal prices

Table 9.2 Indexes of real commodity prices, 1960s–2008 (2000 = 100)

Commodity	1960s	1970s	1980s	1990s	2000–04	2005–08
Food	196.0	208.2	146.9	106.5	102.5	113.0
Agricultural raw materials	89.7	89.6	84.1	94.2	95.3	83.9
Beverages	246.6	293.9	207.9	119.0	100.5	120.0
Oil	23.3	60.0	102.6	57.2	98.2	189.1
Metals	178.3	173.1	110.6	89.6	96.9	182.2

Sources: World Bank, *World development indicators* (Washington, DC: World Bank, various years); International Monetary Fund, *International financial statistics* (Washington, DC: International Monetary Fund, various years). Note: Values are deflated by the export unit value of advanced economies. The IMF recently updated the weights of the indexes; therefore, the numbers for some of the series have changed from previous versions.

increased until mid-2007 from the very low levels of the early 2000s, real agricultural prices stayed well below the levels of the 1960s and 1970s. In late 2007 and early 2008, the U.S. dollar prices of several agricultural commodities increased still further. Nonetheless, most real prices have remained below the levels of the 1970s (with perhaps the exception of rice, which briefly achieved a new peak). As of this writing, the deepening global economic crisis in the late 2000s is bringing down the nominal prices of most commodities, although adverse weather in some key agricultural producing countries is still supporting agricultural prices.

Capital Flows and Debt

Capital flows to developing countries have gone through two cycles. The first cycle peaked in the early 1980s, when capital flows reached more than 2 percent of the combined GDP for developing countries; it then declined during the debt crisis of the 1980s to a low of 0.6 percent of GDP in 1986. The second cycle began in the early 1990s. Capital flows peaked in 1995 at about 2 percent of GDP and dropped again during the series of developing-country crises of the late 1990s and early 2000s. They reached a low of 0.8 percent of GDP in 2002. In the early 2000s, private capital flows to developing countries began to increase again until about 2007 (although at the same time official capital from several developing countries flowed to the United States and other industrialized countries, where monetary authorities of some developing countries invested their reserves).

The behavior of capital flows has several implications for the economy, for tradable sectors (like agriculture), and for the poor. Capital inflows usually promote growth and investment, but overvaluation of the domestic currency can hurt tradable sectors. Capital flows can experience sudden reversals, which may lead to depreciation of the domestic currency, to banking and fiscal crises (when domestic private and public debt in dollars is widespread), and to sharp declines in growth.

Therefore, ebbs and flows of capital to developing countries have been associated with booms and busts in those countries.

During an upswing in capital inflows, the impact on the poor will depend on their position in the economy and the nature of the growth process generated by the capital inflows. In principle, the urban poor and those working in nontradable sectors would benefit more than the rural poor during periods of growth associated with continued inflows of capital. If growth is sustained, however, benefits accrue to all the poor, albeit to different degrees. When changes in financial markets lead to sudden outflows of capital and growth collapses, the welfare of the urban poor and those working in nontradable sectors tends to suffer the most.

The global financial crisis that started in the second half of 2007 has led to significant declines in capital flows to developing countries, raising the specter of a new bout of financial crises in those countries.

Implications for Poverty in Developing Countries

The previous section described separate basic macroeconomic developments at the global level. This section presents a brief chronological discussion of those trends and their impacts on poverty.

The 1960s and 1970s

As mentioned, the 1960s and 1970s were years of high growth, moderate inflation, low (and even negative) real interest rates, accelerated expansion of trade, and high real commodity prices. The economic buoyancy of those years was based on expansionary macroeconomic policies in many countries and stable exchange rates, coupled with the expansion and liberalization of international trade. This world macroeconomic configuration helped the relatively resource-abundant primary exporters of Africa and Latin America, which also received much of the capital flows. Latin America and the Caribbean and Sub-Saharan Africa were the two fastest-growing regions during the 1960s, and they continued to grow strongly during the 1970s, although East Asia's growth began to overtake that of all developing regions in that decade. North Africa and the Middle East also benefited from higher oil prices in the 1970s. Rents from natural resources financed both the development of the industrial sector and the expansion of the welfare state to different degrees in many developing countries. The World Bank, in its 1990 *World Development Report*, said that from the 1960s to the early 1980s there was "considerable progress in reducing the incidence of poverty, a more modest reduction in the number of poor, and achievement of somewhat better living standards for those who remained in poverty" (40).

The 1980s

The breakdown of the Bretton Woods system of fixed but adjustable exchange rates and the oil shocks of the second half of the 1970s changed world macroeconomic conditions. After the second oil crisis at the end of the 1970s, inflation jumped to double digits, and industrialized countries shifted their priorities from sustaining growth to fighting inflation: the expansionary policies of the previous decades were reversed. Real interest rates skyrocketed, and growth dropped sharply. By the mid-1980s, real commodity prices had collapsed, and they continued declining in the 1990s. Countries that borrowed against expectations of high commodity prices, mainly in Africa and in Latin America and the Caribbean, entered a period of debt distress and economic crises that increased poverty. Although some of the development strategies followed by those countries precluded easy adaptation to the new circumstances, the impact of the 1980s shocks made a painful process of adjustment inevitable.

Depressed world prices of food and agricultural products during the 1980s and 1990s—in part also related to agricultural protectionism and subsidies in industrialized countries—appear to have discouraged investments in the rural sectors of many developing countries, with negative consequences for the poor, who mostly reside there. The lack of rural dynamism also contributed to rural migration to the cities and to premature or excessive urbanization in many developing countries. The World Bank and other development banks cut loans to agricultural and rural development projects, partially influenced by low world agricultural prices that reduced the returns of projects in that sector. Low food prices also seem to have pushed several developing countries, particularly in Sub-Saharan Africa, into a more extreme specialization in tropical products, increasing their external vulnerability and transforming many of them into net food importers that came to depend on subsidized food from abroad. At the same time, however, low prices, other things being equal, should have helped net consumers of food, particularly the urban poor. The net impact on poverty of those developments differs by country depending on the particular constellation of price, investment, employment, and external vulnerability conditions.

Asian countries in general adjusted earlier and more efficiently to the economic shocks of the 1980s than did countries in Africa and Latin America. They also began with lower levels of indebtedness, partly because they were, with some exceptions, not resource-abundant, commodity-exporting countries and therefore could not borrow much in international markets during the time of high commodity prices. Also, the relatively more resource-constrained countries of Asia were increasingly importing primary goods and gradually specializing in exporting manufactured goods. As a consequence, they were less affected by the decline in commodity prices and eventually benefited from it.

The heterogeneous performances of Asia on one hand and Africa and Latin America and the Caribbean on the other were then in part related to the different policy reactions. But the decline in world export shares of Africa and Latin America also reflected the fact that these regions were more dependent than Asia on industrial countries' demand for agricultural products and that agricultural and trade policies in rich countries were changing in ways that undermined agricultural and agroindustrial production and exports from Africa and Latin America. Another important development was the relocation of cold war confrontation from Asia in the 1950s and 1960s to Africa (and Central America) in the 1980s. Africa thus suffered a triple shock in the 1980s: a macroeconomic and debt crisis, a commodity crisis, and a geopolitical crisis, with devastating effects that are still felt in the region.

Regional poverty trends during the 1980s followed overall economic and political performance in the regions: the share of people living in poverty dropped significantly in East Asia and South Asia (where growth rates exceeded those in other developing regions) but increased in Latin America and the Caribbean and Sub-Saharan Africa.¹ At a poverty line of US\$1.00 a day, the poverty headcount went from about 67 percent in East Asia and 42 percent in South Asia in 1981 to 39 percent and 34 percent, respectively, by 1990. In Latin America poverty increased from about 7.7 percent in 1981 to 9.2 percent in 1984 and was still at 8.9 percent in 1987. In Sub-Saharan Africa poverty moved from 42.6 percent in the early 1980s to more than 45 percent in the mid-1980s and 47.5 percent in 1990. Similar trends are observable at poverty lines of US\$1.25, US\$2.00, and US\$2.50 dollars a day.²

The 1990s

During the second part of the 1980s, the United States continued easing its monetary policy, particularly after the 1987 stock market crash. This expansionary monetary policy eventually led to the boom and bust associated with the housing market and the crisis of the U.S. system of mortgage banks in the late 1980s. The oil price spike associated with the first Gulf War also contributed to the downturn at the beginning of the 1990s.

The American recession, coupled with low real interest rates in industrialized countries, sent capital flowing back to developing countries, particularly in Asia, in the first half of the 1990s. U.S. monetary authorities initiated a period of tightening in the second half of the 1990s amid concerns about increasing inflationary pressures. Capital flows to developing countries stopped and reversed once interest rates and the value of the U.S. dollar began to increase in the second half of the 1990s. A second wave of developing-country debt crises erupted, first in Mexico in 1995, then in several countries of East Asia in 1997, Russia in 1998, Brazil in 1999, and Argentina in 2001.

The sudden emergence of financial crises and the subsequent disruption of the economies of many Asian and South American countries affected the poor. World Bank data show that in general, the percentage of poor people increased in Latin America and the Caribbean (from about 6 percent in 1993 to almost 7.4 percent in 1999, using US\$1.00 a day as the poverty line) and stayed the same or declined very slowly in Asia and Sub-Saharan Africa during the second half of the 1990s.³ These figures are regional aggregates, however, and only some (mostly middle-income) countries were affected by financial crises. In the countries affected, the financial crises had clear negative impacts on poverty: the median value of the percentage of poor people living on less than US\$1.00 a day increased from 5.2 percent before the crisis to 7.3 percent afterward; the median value of the percentage of people living on less than US\$2.00 a day jumped from 23 percent to almost 28 percent.⁴

The 2000s

In the late 1990s, the United States went through a new wave of overinvestment, particularly in technology-related industries, that eventually led to a slowdown in the early 2000s.

Several global developments, which began to emerge in the mid-1990s and hit with full force once the world slowdown of the early 2000s was over, began to impart an increasingly expansionary tilt to macroeconomic policies worldwide. The millions of workers incorporated into the global economy because of the policy changes in China and the end of the cold war put downward pressure on salaries and prices of manufactured goods, helping reduce inflationary trends. This situation, in turn, allowed central banks in industrialized countries to maintain more expansionary monetary policies than would otherwise have been possible. In the case of the United States, the easing of monetary conditions started with concerns about the impact of the year 2000 on computer networks and was reinforced after the “dot-com” collapse and the terrorist attacks of September 11, 2001. Until 2004, nominal rates were kept at very low levels not seen since the 1950s and were held low much longer than in the 1950s.⁵ This exaggerated monetary policy eventually led to the economic acceleration that the United States and the world experienced in the 2000s until recently.

This expansionary monetary policy was reinforced by significant increases in private leverage (that is, the amount of credit and debt for a given level of income and capital) that were based on a perception of lower risk, fostered by three factors. First, since the mid-1990s the world had experienced relatively high levels of growth and low volatility, which some have dubbed the “Great Moderation.” Second, technological innovations in credit instruments seemed to reduce risk (in the case

of credit default swaps) or disperse it in a more manageable way (in the case of securitization and tranching of asset-backed instruments). And third, new institutional arrangements emerged, such as the parallel banking and financial structure (which some have called “the shadow banking system”) that has engaged in short-term borrowing and long-term lending, using securitized financial vehicles on both ends.⁶

As a consequence of the decline in the *individual* perception of risk by economic agents, the *system* as a whole took on much more risk than previously understood. Increases in leverage led to two bubbles in the 2000s: in housing and the stock market (the latter of which was a somewhat milder repeat of the late 1990s stock market bubble).

Monetary policies were also expansionary in developing countries. China maintained a semi-fixed exchange rate regime with the U.S. dollar, which generated current account surpluses and an accumulation of reserves, expanding its own domestic money supply and accelerating growth. The Chinese reserves were invested in dollar-denominated instruments, mostly U.S. public bonds, contributing to the reduction of long-term interest rates. Similar mechanisms operated in Asian and Latin American countries: to avoid the disruptions caused by the financial crises of the 1990s, they accumulated reserves in their central banks, expanding their money supply, and invested those reserves outside their countries, in most cases in dollar-denominated assets, also putting downward pressure on global interest rates. Oil producers (and to a lesser extent other commodity producers), benefiting from the increase in the prices of their products, also accumulated reserves, with similar internal and external monetary consequences.

Developing and emerging countries became net exporters of capital, which, along with traditional surpluses from Japan, went mostly to the United States. The U.S. current account, which had briefly gone back into equilibrium during the recession of the early 1990s, began showing steadily increasing deficits starting in the mid-1990s, until it reached a record of more than 6 percent of U.S. GDP. The continuous expansion of the U.S. trade deficit (reflected in the widening current account deficit) and low interest rates supported global growth. This growth, in turn, began to push up nominal and real prices of several commodities, particularly metals and energy. The devaluation of the U.S. dollar beginning in the early 2000s also added pressure to the prices of commodities.

These capital flows contributed to keeping longer-term interest rates low, and at the same time the U.S. Federal Reserve maintained a policy of very low short-term rates for too long. These factors created the conditions necessary for the rise of the housing bubble and its subsequent breakdown when monetary policy had to be tightened because of inflationary pressures. The accommodative U.S. monetary policy began to be reversed by mid-2004, putting in motion the events that led to the housing and related credit crises of 2007 in several industrialized countries: the

housing market peaked in early 2006 and then started to decline sharply, while the stock market peaked in late 2007 and then turned down.

Clear signs of financial distress in mid-2007 led the U.S. Federal Reserve to adopt a strong change in monetary policy toward a more expansionary stance. The large increases in commodity prices in the second half of 2007 and early 2008 appear to have been influenced by this monetary easing. The shift in monetary policy had led to fears of inflation and a decline in the U.S. dollar, prompting investors to turn to commodities as hedges against inflation in a context in which alternative investments in stocks and other assets did not show good returns. Changes in the trade policies of several key countries also contributed to the run-up in prices. Still most real prices of agricultural goods, as mentioned, stayed below their 1970s levels.

By mid-2008 the initially localized financial stress was evolving into a full-blown financial crisis. The new instruments that were supposed to disperse risk made it difficult to assess where the bad credit was. Economic agents fled to the most liquid assets (cash, guaranteed deposits, and short-term U.S. Treasury bills), forcing the liquidation of other assets. The capital reserves held by the banking system shrank in value because of mark-to-market requirements, enforced by legislative changes approved after a scandal involving Enron, and banks therefore reduced their lending. The unraveling of both bubbles and the tangled and opaque network of financial instruments created around them placed the banking system under stress, generating a run on investment banks and the shadow banking system. A credit crunch ensued. As of this writing, this drama is still unfolding in the form of a global recession that threatens to be the worst in more than half a century.

The implications of these macroeconomic developments for poverty have been very different depending on the phase of the cycle. After the world recovered from the deceleration of the early 2000s, strong growth, falling inflation, and lower volatility translated into declines in poverty (as a percentage of the population) in all developing regions. In fact, World Bank data for 2005 show the lowest levels of poverty for all developing regions (measured as a headcount percentage at US\$1.00, US\$1.25, US\$2.00, or US\$2.50 a day) since comparable numbers have been compiled starting in the early 1980s. Even the absolute number of poor (measured at US\$1.00 a day) declined for all regions from the levels of the late 1990s.⁷

These positive trends were interrupted, however, first by the increase in fuel and food prices of late 2007 and early 2008. In *Global Economic Prospects 2009*, the World Bank estimates that these price spikes may have thrown between 130 and 155 million people into poverty. The economic decline in 2009 is also expected to increase poverty in many developing countries, with estimates that at least an additional 46 million poor people will fall under the dollar-a-day poverty line, compared with the period previous to the crisis (and the number will be even greater if higher poverty lines are used).

Macroeconomic Policies for Poverty Reduction

As discussed, growth cycles and volatility in developing countries since the 1960s have been greatly influenced by policies in industrialized countries that determine global macroeconomic conditions, such as interest rates, capital flows, and commodity prices. Economic downturns in the developed countries have been associated with recessions, economic crises, and poverty increases in many developing countries, and the current global crisis threatens to be the most damaging in many decades. Analyzing poverty trends in developing countries without considering the state of the world business cycle overlooks one of the main determinants of the economic conditions that affect poverty outcomes. Cross-section or panel regressions that arbitrarily average variables over 3 to 5 years without properly considering the turning point of the business cycle will likely cause analysts to draw erroneous, or at least imprecise, implications about the impact of structural and policy variables on poverty.

Now the world faces a key global policy issue: what international arrangements or institutions can coordinate a cooperative solution to the current economic problems and potentially prevent the kinds of imbalances and excesses that caused the current crisis? Discussions within the International Monetary Fund (IMF) have focused on the possibility of strengthening economic policy surveillance in a way that encourages cooperation. Yet the IMF currently does not have the instruments or the governance system necessary to design and implement such an outcome. More recently the Group of Twenty (G-20), which originally included the participation of finance ministers and central bank governors and has evolved into a political body involving presidents, has been trying to articulate a global collective response to the current crisis. The measures discussed in the enhanced G-20 include, among other things, fiscal and monetary policies to restart the economies of the industrialized countries currently in recession, reform and better regulation of the banking and financial systems, and increased financing for world trade and for developing countries through strengthened international financial institutions, including the IMF, the World Bank, and regional banks.

These measures, however, do not address the global imbalances previously discussed, which are linked in part to the U.S. dollar as the main global currency for trade and investment and to the U.S. consumer as the buyer of last resort. A more profound restructuring of global financial and macroeconomic institutions is being discussed, including the replacement of the U.S. dollar with a more truly universal currency based on, and likely going beyond, the special drawings rights issued by the IMF.⁸ A proper resolution of these issues, which will likely occupy politicians and economists in the next decade, is crucial for global macroeconomic developments and poverty trends.

Whatever happens at the global level, these macroeconomic uncertainties and challenges raise the question of what developing countries should do internally to try to smooth the business cycle, avoid economic crises, and thus reduce poverty and hunger. To that end, developing countries should (1) strengthen the fiscal positions of their public sectors, reducing public-sector debt ratios, using additional resources from high commodity prices countercyclically, and creating fiscal space to establish safety nets for the poor and vulnerable; (2) avoid rigid and appreciated real exchange rates that may lead to trade imbalances and excessive accumulation of external debt; and (3) maintain a reasonable level of reserves in central banks as a precaution against possible global turbulence that could lead to declines in growth and commodity prices, possibly stopping capital flows to developing countries. In general, many developing countries seem to have been following these policies more closely than in the cycles that ended in debt crises in the 1980s and 1990s.

Even if this downturn is properly managed, however, developing countries face more difficult challenges for economic development and poverty alleviation in the medium to long term. In the most likely medium-term scenario, the industrialized economies, and particularly the United States, will resume growth sometime in late 2009 or, more likely, 2010. But this growth will be at a lower rate than it was in the mid-1990s and mid-2000s, leading to an overall lower rate of world growth, at least during the first half of the next decade. There are several reasons for this scenario. First, governments will need to make fiscal adjustments after the increases in public expenditures and debt undertaken to support the financial sector and the economy. Also, they will have to reverse the expansionary monetary policies followed so far. Second, consumers, especially in the United States, who increased their debt ratios during the 1990s and 2000s, will have to save and reduce those ratios to more manageable levels. Third, the financial sector emerging from this crisis will be more regulated, use less leverage, and, it is hoped, be more prudent in its financial practices. All in all, expenditure adjustments in the public and household sectors in the United States, along with less abundant credit, will lead to lower U.S. trade deficits. The world will thus not have the consumption engine that propelled growth during the past two decades (U.S. consumption is about 32 percent of world consumption, whereas total consumption in developing countries, including China and India, is only about 20 percent).

A second medium-term scenario is also possible if countries repeat their behavior of the second half of the 1970s. The industrialized countries countered the 1974 oil shock with expansionary macroeconomic policies that led to further inflationary pressures in the late 1970s and a complete policy reversal in the 1980s, forcing a deep recession. Now, if the current expansionary fiscal and monetary policies in the United States and other industrialized countries are not promptly adjusted

once the worst of the current economic crisis is over, a scenario could materialize in which inflation would move sharply higher in three to four years, forcing a drastic monetary contraction.

In the first scenario, progress in reducing poverty will be slower, and in the second, poverty levels will actually increase.

In the longer term, the main challenges appear to be linked to the interaction of energy, agriculture, the resource base, climate change, and the environment.⁹ Even without accelerated growth, potential imbalances loom in world energy markets in the coming years, and the implications of energy consumption for climate change may carry significant and troubling consequences for many developing countries in the longer term. The complex issues linking energy use, economic development, poverty alleviation, and climate change are also affected by a market coordination failure of global proportions, which—like the shorter-term macroeconomic imbalances—lacks a widely accepted and truly operational international mechanism for resolution.

The welfare of the whole world, and the fate of the poor, will depend on how industrialized and developing countries resolve those two big coordination problems: first, macroeconomic imbalances in the shorter term, and second, market and institutional failures associated with energy and climate issues, which over time will become ever more relevant for poverty trends in developing countries. Building a world economy that is macroeconomically stable, based on sustainable energy, and capable of ensuring the benefits of progress for everyone requires that humankind properly address those two crucial issues of global governance.

Notes

1. S. Chen and M. Ravallion, The developing world is poorer than we thought, but no less successful in the fight against poverty, World Bank Policy Research Working Paper 4703, Development Research Group, World Bank, Washington, DC, 2008, <http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/08/26/000158349_20080826113239/Rendered/PDF/WPS4703.pdf>.

2. Ibid.

3. Ibid.

4. E. Díaz-Bonilla, *Global macroeconomic developments and poverty*, IFPRI Discussion Paper 00766, International Food Policy Research Institute, Washington, DC, 2008, <<http://www.ifpri.org/pubs/dp/ifpridp00766.pdf>>.

5. The effective federal funds rate was about 1.4 percent (nominal) for the period from December 2001 to December 2004, similar to the nominal rates from mid-1954 to the second half of 1955 and again during part of 1958. In the 2000s, however, rates were kept low for about three years, whereas in 1954–55 they were kept low for only about 15 months and in 1958 for just 10 months.

6. The core banking system has promoted this parallel institutional structure as a way of avoiding strict capital conditions and regulations, using the argument that by using instruments

from capital markets (instead of simply taking shorter-term deposits to make longer-term loans), they could more efficiently allocate risk. These operations were supposed to remain off the banking sector balance sheet, and they used securitized financial instruments (some of which were based on housing mortgages) instead of deposits and loans. That parallel system amplified the availability of liquidity, which was already ample because of Federal Reserve policies, providing further support to U.S. and global growth.

7. Chen and Ravallion.

8. See, for instance, United Nations, *Report of the UN Commission of Experts on Reforms of the International Monetary and Financial System, chaired by Joseph Stiglitz*, United Nations, New York, 2009, <<http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf>>.

9. See Díaz-Bonilla.

For Further Reading

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