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The Global Financial Crisis and Countercyclical Fiscal Policy

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Contents

I. Introduction: Sub-Saharan countries and the Crisis.....	3
II. Introduction: Role of Fiscal Policy	5
III. Countercyclical Fiscal Intervention	7
IV. Exchange rate management	12
V. Constraints on Macro Policy.....	14
VI. References.....	17

The Global Financial Crisis and Countercyclical Fiscal Policy*

I. Introduction: Sub-Saharan countries and the Crisis

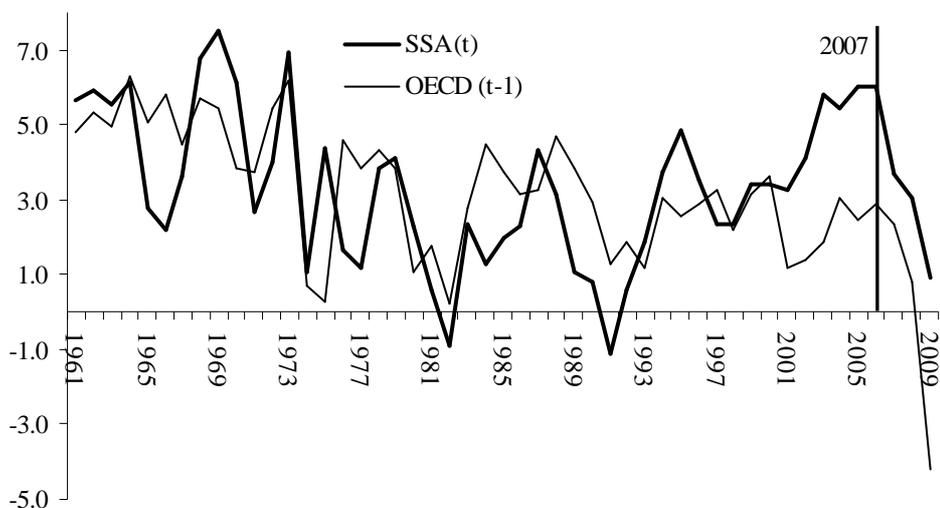
What began as a financial crisis concentrated in the United States of America spread through major developed countries and into the middle income countries of Latin America, Asia and North Africa. Initially there was hope that low income countries, because of their underdeveloped financial sectors, might be spared from the crisis. However, emerging evidence suggests that by the end of 2008 the effects had reached the countries of the sub-Saharan region.

Evidence from almost fifty years indicates a close correlation between the growth of the developed countries and the sub-Saharan countries, shown in Figure 1. When one adjusts for the very low growth rates of the sub-Saharan region in the 1980s and 1990s, statistics reveal that a one percentage point change in the average growth rate across the OECD countries was associated with a change in the sub-Saharan average of .42 percentage points with a one year lag.

Applying this simple relationship, the OECD growth rate for 2008 and projected rates for 2009 and 2010 can be used to estimate the rates for the sub-Saharan. After a six percent average across the countries of the region in 2007, the estimated and projected rates are 3.7 (2008), 3.0 (2009), and less than one percent (2010), a severe downturn after the brief growth recovery during 2003-2007. The challenge to the policymakers of the sub-Saharan region is to design macro policies to prevent this collapse of growth rates.

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Figure 1: Growth of the OECD Countries and the Sub-Saharan Countries, annual values 1961-2010



Notes:

The OECD average is lagged one year. The OECD growth rate for 2008 is actual value, 2009-2010 are projections. The sub-Saharan values for 2008-2010 are estimated from the following equation (probability that the coefficient is zero is given under the coefficient):

$$y(SS) = .027 + .426y(OECD) - .019D(82-99)$$

(.000) (.011) (.001)

Adjusted R2 = .387

Degrees of freedom = 43

D(82-99) is a binary variable with a value of one for 1982-1999.

Sources:

World Bank: <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/>

OECD:

http://www.oecd.org/document/61/0,3343,en_2649_34573_2483901_1_1_1_1,00.html

II. Introduction: Role of Fiscal Policy

Because of their dependence on commodity exports with volatile world prices, growth rates of developing countries tend to fluctuate more than rates for advanced industrial countries. This is particularly true of sub-Saharan countries, which except for South Africa have few manufactured exports. The orthodoxy before the current financial crisis was that liberalising the external current account and deregulating the capital account would create relative price adjustments that would reduce the effects of the external ‘shocks’ that destabilise growth. However, empirical evidence suggests that in the 1990s and 2000s growth rates in the sub-Saharan region were as or more unstable than before the liberalising policies of the 1980s (see Weeks 2008 and 2009a; Weeks and Geda 2007).

Until 2008 the macro policy framework common to most African countries was based on the hope that relative price changes would allow economies to approach their growth potential: a programme generalising deregulation across all markets, combined with a cautious monetary policy and a neutral fiscal policy would enable these relative price changes to be realised in practice. This analysis, known technically as the ‘price constrained framework’, has as its prerequisite that the world economy is operating near its potential.¹ Since mid-2008 it has been clear that the world economy is quantity constrained: aggregate demand is insufficient to permit the world economy to achieve its potential. For this reason the governments of the major industrial countries have introduced ‘stimulus packages’ of varying sizes, designed to replace the fall in private sector demand with public sector expenditure.

What is true for the advanced countries can also apply to developing countries. Lower demand from the advanced countries means lower expenditures by households and businesses on internationally traded commodities. World trade in the major export commodities of African countries, from cotton to cocoa, has fallen in the last twelve months. Declining prices of these commodities cannot restore their quantities and values to their pre-2008 level. The fundamental problem is not that the commodities are too expensive, but that there is a deficiency of demand at any price of a specific commodity and at any set of relative prices. Were it the case, for

¹ The theoretical and policy difference between ‘price constrained’ and ‘quantity constrained’ economies is discussed in Weeks (1989). The recently revised edition can be found at <http://jweeks.org>.

example, that Sierra Leone's exports of cocoa did not fall, this would mean that the cocoa exports of some other country fell.

In the context of a demand constrained world economy, African governments have two general policy options. Governments can pursue a 'business-as-usual' and 'hope-for-the-best' option in which they continue with the policy framework designed for a robust world economy and await international recovery. This would mean continuing to follow advice to place primary emphasis in macro policy on preventing inflation, attempting to reach a target for the fiscal deficit, and maintaining a free-floating exchange rate.²

Choosing this option, as Dr Johnson said of second marriages, would represent a triumph of hope over experience. When the world economy is deflating a fiscal policy guided by fears of inflation would result in a contraction of the demand for domestic goods to aggravate the contraction in exports. As the economy contracted due to the world recession and a restrictive fiscal policy, any deficit target would become more difficult to realise. A reduction in expenditure, or an increase in taxes, would further depress private domestic expenditure, which would reduce revenue from sales taxes. For example, an attempt to reduce the fiscal deficit by one percentage point would require a reduction of national income by a multiple of one percent. The nominal depreciation of a floating exchange rate in the context of lower export demand could result in a declining economy aggravated by an inflationary spiral.

The other option, adopted by most governments in rich countries, has been an active fiscal policy, to reduce the impact of the international downturn through purposeful management of the public budget. The policy objective is to compensate for fluctuations in private sector demand by use of 'countercyclical' fiscal policy. After it fell out of political fashion for almost three decades, opinion has moved back in favour of countercyclical fiscal intervention.

A January 2009 IMF report on the world economy called for a 'firm commitment' to a 'timely implementation of fiscal stimulus across a broad range of advanced and emerging economies'. In line with this commitment, a May 2009 press

² A clear statement of this approach is found in an IMF report on the global financial crisis, Countries should focus on macroeconomic stability. In some countries with falling inflation there may be scope for monetary easing; others, however, still experience continued or renewed price pressures. Those with flexible exchange rates should allow them to move, so that they function as shock absorbers. (IMF 2009a, viii)

release reported that the IMF recommended a fiscal stimulus for a low income country, Mozambique.³ In its survey of the impact of the financial crisis, the World Bank also recommended that governments ‘assess their ability to undertake countercyclical policies’.⁴ The African Development Bank as well has recommended countercyclical fiscal intervention.⁵ Without explicitly mentioning countercyclical measures, in 2009 the IMF recommended for Sierra Leone that the country’s fiscal deficit be allowed to increase to respond to the impact of the financial crisis on import prices.⁶

These statements and recommendations by international agencies suggest that a new policy consensus is emerging in favour of countercyclical responses to the world downturn. It is appropriate that policy makers in Africa take advantage and follow this emerging view. This paper considers how the countries of Africa might design and implement such a policy.

III. Countercyclical Fiscal Intervention

Countercyclical Expenditures

Countercyclical policy increases demand when the economy grows below its long run potential, and decreases it when output rises towards its potential, where there appear resource scarcities and inflationary pressure. Taxes can be used for countercyclical intervention, but in practice they are a clumsy instrument for demand management. Changing the public sector’s net contribution to aggregate demand with

³ The complete passage reads as follows,

In current circumstances, the timely implementation of fiscal stimulus across a broad range of advanced and emerging economies must provide a key support to world growth. Given that the current projections are predicated on strong and coordinated policy actions, any delays will likely worsen growth prospects. Countries that have policy room should make a firm commitment to do more if the situation deteriorates further. Fiscal stimulus packages should rely primarily on temporary measures and be formulated within medium-term fiscal frameworks that ensure that the envisaged build up in fiscal deficits can be reversed as economies recover and that fiscal sustainability can be attained in the face of demographic pressure. (IMF 2009c, 1)

A press release titled ‘IMF Mission Calls for Fiscal Stimulus in Mozambique’ states, ‘In the short term, given Mozambique’s low level of public debt, the [IMF] mission sees scope to at least partly offset the impact of the global economic crisis on Mozambique with somewhat more expansionary fiscal and monetary policies. (IMF 2009d).

⁴ ‘The challenge for policymakers in this environment is to assess their ability to undertake countercyclical policies given the resources available to them as well as their institutional and administrative capacity to rapidly expand and adapt existing programs.’ (WB 2009, 10)

⁵ The AfDB’s 2009 report calls on donors and lenders to ‘[Focus] on results, rather than prescribing rigid policies and actions, allowing countries space to respond according to their particular needs and circumstances.’ More specific, it recommends that donors and governments ‘[i]ncrease flexibility in macroeconomic frameworks to allow more scope to balance macroeconomic stability and the need to stimulate domestic demand.’ (ADB 2009, 2)

⁶ ‘[IMF] Staff is proposing that the primary fiscal deficit be revised upward by 0.4 percentage points of GDP to accommodate the unanticipated budget impact of the rise in world oil prices.’ (IMF 2009b, 5).

the tax instrument requires either new taxes or altering rates. In most countries both require legislative action, followed by changes in administrative procedures. This can be a lengthy process that fails to achieve demand changes with the speed necessary to respond to changes in private demand. Public expenditure offers the more effective mechanism for compensating for private demand fluctuations.

A country's medium and long term growth rates are determined by the development of capacity, skills and technical change, with the last embodied in capital investment. Since public investment contributes to increasing capacity, it is unwise to use it as a countercyclical instrument. Because public investments by their nature mature over several years, to use them as a countercyclical instrument would imply abandoning or suspending capital projects, resulting in waste of resources. The expenditure flexibility necessary for an effective countercyclical policy must be found in the current account of the public budget.

To summarise, if a country's potential growth rate is low, increasing public investment subject would be the appropriate response. Simultaneously a government would use current expenditure to generate the demand necessary to reach the greater potential created by the public investment. Public expenditure is a more effective instrument for countercyclical intervention than taxation, because of the relative inflexibility of the latter. Capital projects are inappropriate because they often cannot be initiated quickly enough to respond to demand declines, and cannot be stopped without wastage when the economy becomes over-heated. Much of current expenditure is also inappropriate because it is not practical or rational to suspend it. For example, it would not be rational health or education policy to hire more medical staff or teachers during a downturn and lay them off when the economy recovers.

Effective countercyclical expenditure would be based on what might be called 'semi-capital' programmes, defined as programmes that use relatively employment intensive techniques to create rapidly completed facilities that have a large component of repair and maintenance, similar to what the ILO defines as 'labour-intensive public works'.⁷ Examples of such programmes are digging sanitation ditches, repair of public buildings, environmental improvement through erosion reduction, and clearing of rural footpaths. These activities are currently being implemented throughout Sierra Leone by the National Commission for Social Action.

⁷ See, for example, the ILO website on this type of project, <http://www.ilo.org/public/english/employment/recon/eiip/index.htm>

Such projects would make a contribution to community welfare, and their primary purpose is to increase expenditure through the consumption outlays of those employed directly and indirectly. These programmes would be:

- 1) identified and 'stock-piled' prior to the need for them, with accounting procedures in place to reduce the likelihood of misuse of funds;
- 2) easily initiated and quickly terminated, implying that they should be implemented by the central government in order to avoid delays due to limited administrative capacity of local governments; and
- 3) designed so that wages and salaries are the major element of expenditure, with a low capital component.

Some issues that plague public works projects with controversy need not be relevant for ones whose purpose is primarily countercyclical. For example, the wage at which workers are paid is a secondary consideration because these are not long term or even medium term employment schemes. While projects for a countercyclical demand impact should not pay wages that disrupt local labour markets, their impact on internal migration will be limited because of their short term nature. Further, these programmes would be introduced when the labour is in excess supply, and would be unlikely to affect prevailing wage rates. A recent study in Sierra Leone by MoFED experts recommended this type of employment programme, 'cash for work', as a possible policy measure to counter the effects of the financial crisis (MoFED-EPRU 2009).

Finally, and of great practical importance, clear rules should be established for the initiation and termination of countercyclical projects. A 'countercyclical' expenditure that becomes permanent negates its purpose. Initiation and termination could be triggered by a policy rule based on appropriate macroeconomic indicators. The specific indicator will vary by country, determined by the development and structure of the economy.

The programmes that could effectively serve as countercyclical interventions exist in Sierra Leone, administered or executed by the National Commission for Social Action (NCSA) and the Youth Employment Scheme (YES). Both have demonstrated their effectiveness. Both are relatively small and their primary function

is not to have an impact on the macro economy but to generate employment.⁸ Currently supported by donors, the World Bank in the case of the NCSA projects, these programmes could be funded from the government budget as its countercyclical instruments.

If the size of the stimulus required to prevent an economy from declining is large, some donor support in addition to current commitments might be required. However, donor funding does not lend itself to countercyclical expenditure because of its fixed schedule of allocation and disbursement. To make their funding more appropriate for countercyclical programmes, donors could adjust their allocation procedures to allow for an ‘aid fund’ analogous to funds created for resource booms. Money could be drawn from such a fund when the economy was below potential, and ‘hoarded’ when the economy approach full potential. If donor grants are primarily used to fund public investment, they would not be used for countercyclical expenditures for reasons explained above.

As a practical matter, the countercyclical fiscal stimulus in most African countries must be largely funded by public sector borrowing. If the implied increase in the deficit exceeds a level consistent with achieving other policy goals, such an inflation target or size of the domestic public debt, increased grants should be sought to fill the funding shortfall. Inflationary pressures and domestic debt accumulation are discussed in the next section.

Arguments over deficits

As discussed above, the use of the public sector balance between revenue and expenditure as a tool to stabilise economies near full potential was generally accepted as sound macro management prior to the 1980s. Active fiscal policy passed out of fashion due to political changes in advanced countries. Abandoning an active fiscal policy was justified on technical grounds by two arguments: the possible inflationary effect of deficits, and the putative tendency for public borrowing to ‘crowd out’ private borrowing by causing interest rates to rise. The analysis of the relationship between public deficits and inflationary pressures is straight-forward.

If the economy is operating at full potential, increased spending from any source, public or private, must result in a reduction of expenditure of another type. If

⁸ The most important NCSA project is supported by US\$ 4 million from the World Bank. It employs about 14,000 people in activities of infrastructure maintenance. The YES projects are more varied including both employment and ‘franchising’, which in practice means selling goods on commission.

the expenditure is by the public sector, its inflationary impact will depend on how it is financed. If the expenditure is financed through borrowing, creating or increasing the fiscal deficit, the borrowing can be through sales of government securities to the private sector ('open market operations') or by the ministry of finance borrowing from the central bank ('monetising the deficit').

Bonds sales to the private sector ensure that the expansion of the deficit is not inflationary, because the net change in the money supply is zero. The government takes money out of circulation by the bond sale, and returns the same amount to circulation through its increased expenditure. If the private sector holds its desired amount of bonds before the increased public spending, it would be necessary for the government to offer the bonds above the prevailing interest rate in order to sell them successfully. If the increased bond rate transmits to private financial markets, 'crowding out' of private sector borrowing would occur if private investment is sensitive to formal sector interest rates. If the government borrows directly from the central bank, the money supply increases and, with the economy at full potential, inflation results. There is an important exception to this. If the economy is open, the increased money in circulation will in part or whole be spent on imports, reducing the inflationary impact, but creating or increasing a trade deficit.

If the economy is operating a less than full potential, neither type of deficit financing should generate more than minor and transitory inflation, though 'crowding out' could occur. An increase in government expenditure financed by bond sales to the private sector would increase aggregate demand. With no change in the money supply, implied by open market operations, the increased output would generate upward pressure on interest rates, depressing private investment expenditure. As a result the net change in aggregate demand would be less than the increase in public expenditure, though still positive. Financing the expenditure by direct borrowing from the central bank would imply that the increase in aggregate demand would equal the increase in public expenditure. Monetising the deficit generates an increase in the money supply sufficient to circulate the increased output that results from more public expenditure.

Few sub-Saharan countries have sufficiently developed bond markets to allow for fully effective open market operations. In the absence of an effective secondary bond market (re-sale market), the major motivation of commercial banks to hold public bonds is statutory requirements on the composition of bank reserves. As a

result, high interest rates are required to induce banks to purchase bonds beyond legal requirements. In addition, commercial banks play a limited role in financing productive investment in most sub-Saharan countries. The combination of the absence of a secondary market and high yields on public bonds implies that financing deficits by bond sales has the perverse effect of further discouraging commercial banks from funding productive investment, which are riskier than holding government securities.⁹ The major economic effect of higher interest rates is to increase the cost of servicing the domestic public debt.

With the economy well below its potential with idle land and labour, monetising the deficit is an effective tool for the expansion of aggregate demand, generating neither inflation nor ‘crowding out’ of private expenditure. The government’s expenditures on infrastructure could be consciously designed to ‘crowd in’ private investment by lowering costs of transport, electricity and water supply. In the context of some African countries, the cost of servicing the public debt is a greater concern than inflation or ‘crowding out’.

In summary, the proposed increase in the fiscal deficit would be unlikely to generate inflationary pressures, and even less likely to provoke a ‘crowding out’ of private expenditure. The net increase in the public debt would be minor. There is no important technical argument against a stimulus package that relies on financing increased expenditure by monetising the deficit.

IV. Exchange rate management

In many cases, fiscal expansion will need to be accompanied by a rise in the exchange rate, either as an automatic response (depreciation) or by conscious management (devaluation). To achieve the desired outcome of preventing a decline in the economy, the exchange rate adjustment accompanying the fiscal stimulus should be consciously managed. Management is necessary in order to prevent a deterioration of the trade balance.

The fiscal expansion, by increasing output and private demand, will increase imports and generate a trade deficit or make an existing deficit larger. This is the problem that tended to undermine the use of active fiscal policy in developing countries in the past, and to discredit it as an instrument of macro management.

⁹ This process is discussed in detail for Zambia in Weeks, et. al. (2006).

Exchange rate depreciation or devaluation can be used to counter the tendency of fiscal expansion to create an unsustainable trade balance. To be effective, the depreciation or devaluation must increase the price of traded commodities compared to non-traded commodities.

A necessary and intended result of the depreciation or devaluation is a rise in the domestic price level equal to at least the 'pass-through rate' (marginal propensity to import) times the change in the nominal exchange rate. While necessary and intended, this exchange rate induced increase in the price level creates the risk of destabilising inflation if the nominal devaluation is large. Managing this risk is an essential part of a successful active fiscal policy.

As fashion moved against active fiscal policy over the last three decades, there was a shift to a view that 'flexible' exchange rates are the only practical policy choice for governments. Therefore, it is necessary to explain why exchange rate management by African governments would be both feasible and possible as part of policy to counter the global crisis.¹⁰ Because in practice almost all governments intervene in foreign exchange markets,¹¹ the policy choice is not between 'fixed' and 'flexible' exchange rate regimes, but selection of the most appropriate point on a range of forms and degrees of intervention in the context of the characteristics of the economy (Fischer 2001). From a practical policy perspective, governments and central banks repeatedly shift between 'flexible' and 'fixed' exchange rates. Any time a central bank intervenes to moderate the rise or fall of the national currency, it is 'fixing' the exchange rate, however briefly.

The exchange rate management that would be part of the proposed stimulus package would not seek to maintain a 'fixed' rate for the domestic currency against any foreign currency. The purpose of the intervention would be to control the rate of depreciation of the national currency against the currencies of major trading partners in order to prevent a widening of the trade gap as the economy expanded. The exchange rate managers would face two possible contexts, one in which the fiscal

¹⁰ An argument in favour of a global return to managed exchange rates is found in Rolnick and Webber (1989), who write, 'we maintain there is a convincing case that a fixed exchange rate system is feasible and should be established. Theory shows it feasible, and overlooked empirical evidence shows it possible.'

¹¹ The IMF categorises countries by exchange rate regime, and the Annual Report for 2007 lists only thirty-five countries out of over 150 as having an 'independently floating' exchange rate. Only two were in the sub-Saharan region, Democratic Republic of Congo and Somalia. The listing of the latter seems an anomaly in light of the political turmoil in the country. Another anomaly is the absence of Sierra Leone from the table of exchange rate regimes.

expansion was accompanied by no ‘weakening’ of their currency and another in which fiscal expansion automatically provokes depreciation.¹²

The *devaluation case* occurs if there is no market pressure to weaken the national currency as public expenditure increases. In this case the government must act directly on the exchange rate. The purpose is to raise the price of tradables, which will reduce private import demand and raise the return to exporters. How devaluing the currency would be achieved would be determined by the characteristics of financial and foreign exchange markets in each country. For example, in Sierra Leone it would be done by the government setting a higher Leone price for major currencies in the foreign exchange auction. In the absence of market pressure to weaken the national currency there would be no private speculation to undermine the devaluation. In effect, the government would be implementing temporarily a ‘crawling peg’ exchange rate regime. In this case exchange rate management is necessary to achieve a real devaluation in the absence of market pressure for depreciation.

The *depreciation case* occurs if the fiscal expansion is accompanied by market pressure to weaken the national currency. Exchange rate management becomes more complicated, but is still required and remains manageable. While the market pressure to weaken the exchange rate serves the government’s purpose, intervention is potentially necessary in order to prevent the currency from depreciating at a rate that generates unmanageable inflation pressures.¹³ Because the intervention seeks to slow the depreciation rather than stop it, the likelihood of speculative attack is greatly reduced. In summary, even in the depreciation case, the exchange rate authority should implement *depreciation* in order to prevent excessive nominal exchange rate weakening.

V. Constraints on Macro Policy

Policy Action to Counter the Global Crisis

To counter the effects of the international crisis on the domestic economy, most governments in Africa could initiate a macroeconomic stimulus package. The package would be fiscal expansion complemented by currency depreciation implemented through exchange rate management.

¹² The well-known Fleming-Mundell model predicts that a fiscal expansion would result in exchange rate appreciation. That analysis is not relevant to Sierra Leone because the country has no significant level of portfolio capital flows due to lack of the necessary financial institutions.

¹³ Exchange rate management in Zambia is discussed in detail in Weeks, et. al. (2007).

The fiscal expansion would be largely financed by borrowing from the central bank, with a component of additional external assistance. Exchange rate management is a necessary complement in order to 1) to raise the relative price of tradables to prevent the fiscal expansion from generating an unsustainable trade deficit; and 2) to achieve a real exchange rate associated with the fiscal expansion that is sufficiently trade altering but not excessively inflationary.

The policy package faces two types of constraints on its effectiveness: 1) those arising from the adjustment dynamics of the policy package itself; and 2) those derivative from donor behaviour and conditions. The first type can be managed by the government. The second type requires flexibility on the part of donors and the IMF.

As explained, the most important constraint on a successful outcome of the implementation of the policy package is the inflation induced by the weakening of the exchange rate. Exchange rate induced inflation feeds back into the external sector by reducing the real depreciation associated with any nominal depreciation. The inflation constraint is made tighter by the calculation if economy suffers from a substantial structural rate of inflation. It would be prudent for the government to identify an inflation rate which it considers to be the maximum consistent with macroeconomic stability. This would constrain the nominal devaluation managed by the central bank.

Less important than inflation but significant constraints are the trade balance and the fiscal deficit. In the absence of additional donor support, the stimulus package should not increase substantially the trade deficit, which in many countries is sustainable on the basis of those donor inflows and remittances. This constraint would be loosened by the real devaluation. With the goal of not generating a burdensome public debt, the fiscal deficit should be carefully monitored, though not made a binding constraint.

Depending on the size of the external shock to be redressed and existing donor flows, a country may not require a substantial increase in grants for the fiscal stimulus to be effective in stabilising the economy. However, the government will need donors and the IMF to grant it 'policy space' through the following measures:

- 1) elimination of conditionality and 'benchmarks' for deficit limits, since the stimulus package requires a modest increase;

2) donor reliability on delivery of assistance because the fiscal stimulus will be 'finely tuned' and late or non-delivery of assistance could provoke macroeconomic instability; and, more generally,

3) a suspension of the 'business as usual' approach to negotiations over assistance which emphasise policy issues such as tax reform that the external crisis has rendered of less immediate importance.

The combination of a carefully calibrated stimulus package and donor flexibility offers the firm prospect of overcoming the potentially serious effects of the external shock to the economy. While the stimulus package involves risks, these are minor compared to the certain effect of the global depression on poverty and public welfare.

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