

Calling for Macroeconomic Heresy: An Investment-Focused Recovery

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On September 8th, the Obama administration proposed three new stimulus programs totalling US\$ 350 billion that are designed to boost flagging economic growth. Though the programs have faced heavy opposition in Congress, they have underscored the recent interest in a more investment-focussed fiscal stimulus.

A prominent part of the package is a US\$ 200 billion tax break to businesses that allows them to write off 100% of new investments in plant and equipment. The second part is a US\$ 100 billion extension of business tax credits for research and development. And the third is US\$ 50 billion of new spending in infrastructure.

The emphasis of these programs is not just on reviving aggregate demand but on fuelling long-term growth through expanding the productive capacity of the US economy. Despite running large fiscal and trade deficits, the US still has the 'fiscal space' to finance this kind of investment, based on being the dominant reserve-currency country. Why have developing countries, which have an even greater need for investment financing, not been provided similar 'fiscal space' to fund public investment and stimulate private investment.

Such an investment-focussed economic stance should have come to the fore after 2000 as a corollary of the adoption of the Millennium Development Goals (MDGs). Reaching the MDG targets implied a dramatic scaling-up of public investment in social and economic infrastructure but there was scant attention paid to formulating a public-investment led macroeconomic stance at that time (McKinley 2005).

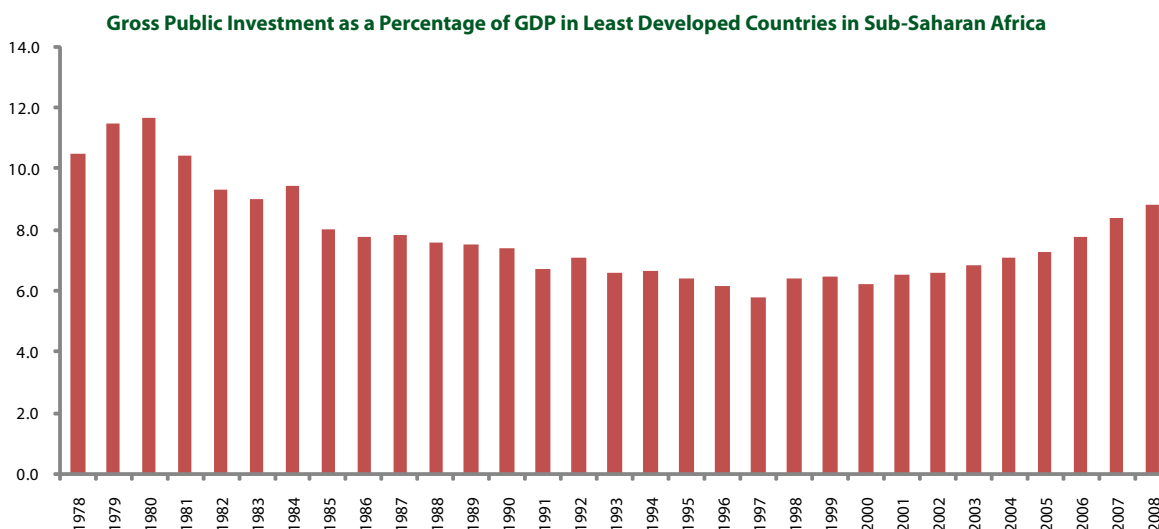
The reigning macroeconomic consensus favoured monetary policies over fiscal policies and accorded little importance to public investment. But monetary policies were governed by a double standard. In some rich countries, such as the US, the UK and Spain, credit policies were blatantly expansive, culminating in rapidly swelling real-estate bubbles. But in most developing countries credit policies remained tight as high real rates of interest accompanied IMF-endorsed targeting of low single-digit inflation rates.

The Macroeconomic Damage

Over time, the effect of such policies has been most damaging in low-income countries. Restrained by high rates of borrowing, both private investment and public investment has suffered. Where growth has accelerated, it has been driven by commodity exports instead of domestic investment. But such growth is not likely to be sustainable.

Take the telling example of public investment in the Least Developed Countries in sub-Saharan Africa—some of the poorest countries in the world. Despite recent advances, public investment in these LDCs has been depressed since the 1980s. After 1980, LDC gross public investment as a ratio to GDP went into a pronounced secular decline (see figure). While in 1980 this ratio was 11.6%, it had dropped to a low of 5.8% in 1997. Thereafter it began to increase slowly, reaching 7.2% in 2005. As economic growth picked up in the mid 2000s, public investment increased further, reaching 8.8% in 2008, the last year for which data are available.

However, public investment has still not reached the levels it had



Source: World Bank (2010). Africa Development Indicators.

Note: Unweighted mean for 30 Least Developed Countries in Sub-Saharan Africa.

achieved prior to the imposition of structural adjustment programmes in the 1980s. Also, the global recession is bound to have reversed some of the most recent gains. In addition, these statistics track gross, not *net* public investment. The latter would take into account the depreciation of the capital stock, which must have been substantial since the 1980s as economic infrastructure has been left to age and decay.

Instead of focussing on investment and the long-term prospects for growth, much of the current discussion of macroeconomic policies—even among progressive economists—remains fixated on short-term policies, namely, *cyclically* reviving aggregate demand and providing forms of social protection, including financing job recovery.

A New Approach

First of all, such an agenda applies more to developed economies than underdeveloped ones. In low-income countries, there is limited ‘fiscal space’—without external financing—to stimulate aggregate demand or fund social safety nets, even if that were the focus. More importantly, policymakers in low-income countries need to think more long term. They have to find financing for investments that will expand aggregate supply, restructure their economies and raise levels of productivity and wages.

Financing for such investments is becoming more readily available from some major emerging economies, notably China, without the imposition of an onerous burden of conditionalities. But the established OECD donors have turned a blind eye to such prosaic economic needs, appealing to their national constituencies to maintain

commitments to Official Development Assistance primarily on the basis of humanitarian and poverty concerns.

As Jeffrey Sachs has noted trenchantly in a recent *Financial Times* editorial (‘Sowing the Seeds of Long-Term Growth’, 22 July 2010), “a new approach to recovery is needed” (see also Sachs 2009). Focusing on the US, Sachs remarks that it should be using “the corrective boost in saving rates to promote long-term investments in physical and human capital as the proper way back to sustained growth”.

His proposal for a “US investment recovery plan” outlines four major areas of investment. The first three include investments in: 1) sustainable energy, 2) cutting-edge infrastructure, and 3) enhanced labour force skills. The fourth calls for credit guarantees to boost “infrastructure exports to Africa and other low-income countries” (as a counterweight to rapidly expanding Chinese influence).

His call to give macroeconomics a more ‘structural’ focus is indeed welcome, although doing so five years ago—when scaling up for the MDGs was most pressing—would have been more opportune. But better now than never, an apparent call for macroeconomic heresy.

References:

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