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Attacking Poverty in the Developing World…

Chapter 18
Macroeconomic Stability and Poverty Reduction

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Macroeconomic instability can have severe consequences for the poor, both directly and by drawing policymakers' attention away from longer-term poverty reduction. It can also wreak havoc on even the best efforts of non-profit development organizations. At the same time, the policies implemented to end the instability (such as cuts in government spending, and currency devaluation) can themselves raise poverty, at least temporarily.

For all these reasons individuals and organizations involved in poverty reduction may naturally be drawn into considering stabilization issues, and even towards direct engagement in macroeconomic policy debates. NGOs' grassroots connections to the households directly affected by stabilization policies render some of the costs of instability and of stabilization policies painfully clear. But debates about stabilization can seem arcane and technical. And detailed analysis of stabilization policies is not something many NGOs feel equipped to do.

This chapter aims to assist the conversation about macroeconomic stability by offering a summary of economic thinking on the topic, with particular emphasis on its relation to poverty. This is not a survey of the vast economics literature that exists on

[1] The views expressed here are solely the responsibility of the authors, and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or of any other person associated with the Federal Reserve System.

stabilization. Instead, we hope to provide a straightforward and intelligible guide to some of the issues posed by macroeconomic instability and stabilization policies.

We begin by describing three common scenarios in which macroeconomic instability arises in developing countries. Though particular institutional details vary from country to country and from case to case, there are large common elements. Macroeconomic instability in and of itself hurts low-income households. Instability almost always requires some kind of macroeconomic adjustment; "stabilization policies" are essentially inevitable. Furthermore, the sooner these policies are adopted the better in order to avoid even more substantial problems for the economy in general and the poor in particular.

We then outline policy measures that can help promote greater macroeconomic stability, and consider some of the merits and shortcomings of standard stabilization policies with respect to their consequences for the poor. Much of the controversy regarding stabilization focuses on the potential for stabilization policies to harm the poor.

We argue that, from an ethical point of view which emphasizes care for the poor, macroeconomic stability is itself a worthy aim of economic policy. But actually achieving macroeconomic stability is difficult. Short-run stabilization policies have real costs, even when they are essential for long-term improvements in an economy and for the poor. Thus a crucial challenge for governments facing macroeconomic instability—and for the economists, NGOs and practitioners who advise them—is to craft carefully targeted social service programs that assist the poor and shield them from the harmful short-term effects of stabilization policy while allowing the genuine benefits of stabilization and growth to be attained. This is no easy task. But it is a task to which

NGOs bring real strengths and where practitioner-economist collaboration could be particularly fruitful.

Common Scenarios of Macroeconomic Instability

It can be hard for western observers to appreciate the full significance of macroeconomic instability because western economies have been more or less stable for the past quarter century or more. These economies have experienced relatively steady economic growth, relatively low inflation and unemployment, and very few economic crises that have threatened to stop a nation's economic life in its tracks. By contrast, many developing countries have experienced considerable macroeconomic instability, manifested in high inflation rates (sometimes well over 100 percent per year), and episodes of sharp decreases in income and employment. When the unemployment rate doubles in the space of a few months, say from ten percent to twenty percent, it represents a gut-wrenching crisis that leaves few households untouched. Macroeconomic instability is also often accompanied by the breakdown of key economic institutions, such as when a nation's entire banking system is closed down or when certain goods are simply unavailable at any price because some foreign exchange transactions are banned. Macroeconomic instability, in short, can lead to grave national crises which impose huge costs and disrupt lives.

We sketch below three types of macroeconomic instability that emerge in developing countries.[2] These scenarios exhibit several common elements which have large implications for poverty reduction.

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[2] Macro instability can arise for reasons other than the ones discussed here. For instance, we do not consider the consequences of economic shocks generated outside the economy, such as sudden changes in

Scenario #1: A Debt Crisis. In developing economies governments face many demands for spending. Education, health care, and sanitation spending is urgently needed. Longer-term development requires spending on improved public infrastructure such as electricity, communication, and transportation. The government may also face pressures to subsidize the cost of various goods and services (for middle and upper classes, not just for the poor). Finally, military expenditures may be substantial, reflecting the influence of the armed services and internal or external national security threats.

Developing economy governments also face obstacles to collecting taxes. Historically, import duties and export taxes were substantial, but many countries have chosen to reduce these taxes in order to stimulate international trade and foreign investment (as discussed in Chapter 15 of this volume). In rich countries government revenue is mainly obtained via sales and income taxes, but these are much more difficult to collect when, as is true in poor countries, a large fraction of economic activity is "informal" with no written records. As a result, developing country governments often rely on a patchwork of revenue sources (such as taxes on banking and real estate transactions), many of which are susceptible to corruption, evasion, and ongoing pressure to establish special exemptions for specific individuals and companies.

Given these obstacles to raising public revenue, the government may seek to borrow funds to pay for expenditures. Such an approach may be sensible if the deficit is

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the price of an important traded commodity or an economic downturn in a trading partner that lowers the economy's exports. The scenarios we outline here are the classic problems that arise when developing countries' own monetary and fiscal policy choices, combined at times with bad luck, generate real difficulties.

assuredly short-lived (e.g., in the aftermath of a natural disaster) and the outstanding level of government debt is relatively low. In contrast, large and persistent government deficits can generate a substantial risk of macroeconomic instability.

The evolution of a public debt crisis is comparable in many respects to what can happen with an individual or family. A prudent household has a sustainable level of longer-term debt (such as student loans or a home mortgage), and maintains minimal balances on its credit cards except perhaps in a medical emergency or other unusual event. In contrast, a household that uses credit to finance ordinary expenditures will face a growing level of debt. As time passes, the household will find itself borrowing even more to cover the additional interest charges, and its debt will accumulate at an accelerating pace. And growing dependence on various credit cards and consumer finance loan will typically lead to higher interest rates that exacerbate the financial difficulties. Finally, when no further credit can be obtained, the household will be forced to make even more drastic spending adjustments than would have been required if the debt spiral had been halted at an earlier stage.

Persistent government deficits can trigger a similar sequence of events, except that the adverse consequences affect an entire country, and especially its poorest citizens. If the public debt is still manageable, the government might avoid further borrowing by raising taxes and cutting spending enough to offset its existing interest obligations. Unfortunately, the first government programs to be cut are typically those oriented towards the segment of the population with the least political clout, namely, the poor. Nevertheless, the budget usually cannot be balanced without cutting back on some popular programs that benefit the upper and middle classes. And as the government debt

continues to accumulate, increasingly sharp adjustments are required to move towards a balanced budget, and the political consensus required for fiscal stability becomes even more difficult to achieve.

With a mounting public debt, individuals and private institutions (such as banks) holding government-issued securities become more concerned about the possibility of default, and start moving their assets towards alternative investments. To engage in continued borrowing, the government must pay higher interest rates to compensate investors for greater perceived risk. Public officials may seek to alleviate the interest burden by shifting the government's debt towards bonds and foreign currency loans that have relatively short maturity (e.g., three months or less); however, these changes have the unfortunate side-effect of making the government's interest obligations more susceptible to foreign exchange rate movements and other short-term fluctuations.

Thus, the later stages of a debt crisis involve an element of self-fulfilling prophecy: as investors become increasingly anxious about the possibility of government default, the government must pay higher interest rates that exacerbate its financial problems and thereby make the default more likely. Such concerns about macroeconomic stability also make it more difficult for households and companies to borrow at reasonable interest rates, thereby contributing to a drop in private spending and higher unemployment. The economic slowdown causes a decline in tax revenue, putting further pressure on the deficit and raising perceptions that the government's budget outlook is not sustainable.

At the culmination of the crisis, the government suspends its debt payments and formally defaults. Unlike an individual household, the government then faces a complex

and protracted process of negotiating new terms with all of its creditors. Until these negotiations are completed, the supply of credit may dry up not only for the government but for domestic households and companies, including many small firms that rely on short-term trade credit for normal operations.

Thus, a debt crisis typically leads to a very sharp contraction in economic activity, with rising unemployment and falling wages. This has particularly severe consequences for low-income households, which will be pushed towards or into poverty. In fact, developing country poverty rates are strongly tied to overall national income growth, so slowdowns or contractions tend to raise poverty directly.[3] And as the government is finally forced to balance its budget, the brunt of the adjustment may occur through drastic cuts in programs that benefit the poor. Even after the government succeeds in renegotiating its debt and restoring a degree of stability to financial markets, the adverse consequences of the crisis may continue to be felt for many years in the form of higher interest obligations and lower spending on programs oriented towards poverty reduction and longer-term growth.

Scenario #2: High Inflation. In addition to providing various services such as education, the government has an additional responsibility for maintaining a stable value of the currency. Low and stable inflation is not only important for economic development, but is also crucial for poverty reduction: low-income households conduct most or all of their transactions in cash, and have limited ability to protect themselves against high inflation.

When public spending exceeds tax revenue, the government may be tempted to print money to cover the deficit. From a short-term perspective, issuing additional

currency may seem relatively painless compared with the prospect of spending cuts, tax hikes, or further borrowing (especially if the government would have to pay high interest rates on any new debt). Nevertheless, "resorting to the printing press" has detrimental consequences for the economy, especially for its poorest members.

Suppose the local currency is the peso. If the government expands the total amount of pesos in circulation while the real quantity of goods and services in the economy is essentially unchanged, then each peso will have less purchasing power. More specifically, the prices of goods and services will tend to rise at roughly the same rate as the supply of money. For example, if the government expands the money supply by ten percent during the month of January, then households might find that a liter of milk which cost 20 pesos at the beginning of the month rises in price to about 22 pesos by the end of the month.

As money-financed deficits push up the inflation rate, low-income households will tend to experience a direct fall in their standard of living, even if their nominal incomes are being adjusted upward at fairly frequent intervals as a result of cost of living increases. Their reliance on cash means that they lose purchasing power with every price increase that takes place between wage rate adjustments. If a worker keeps the income received on pay day in the form of cash and spends it gradually over the course of the month, a high rate of inflation will mean reduced purchasing power later in the pay period. Lower spending may be needed early in the pay period to ensure that enough cash remains to pay higher prices later in the month. In contrast, a wealthy household could deposit the pension payment into a bank account for which the interest rate is automatically adjusted in parallel with inflation, leaving its standard of living unaffected.

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[3] See, out of a large literature on this subject, Deininger and Squire (1996).

Inflation's impact on living standards is even greater for the poor who are recipients of pensions or other incomes whose values are fixed in nominal terms and do not tend to be adjusted for rising prices. For them, the erosion of living standards induced by inflation continues not just between pay periods but across pay periods, sometimes leading once-meaningful sources of income to become trivial in real terms.

Inflation also tends to erode the savings of low-income households, who have few alternatives to keeping their savings in cash. Over the past couple of decades, a number of developing countries have experienced very high and persistent inflation, with monthly rates of 20 to 30 percent that correspond to an annual rate above 500 percent. With such high inflation rates, any cash savings will be virtually wiped out over the course of a year or two. In contrast, households with access to bank accounts and other interest-bearing assets can largely shield their wealth from the "inflation tax."

Furthermore, in an economy with ongoing high inflation, the government often faces increasingly severe difficulties in collecting tax revenue, while the wages of public employees and the costs of other government services may rise roughly in line with the inflation rate. Thus, the government may be forced to rely even more heavily on printing money to finance the widening public deficit, pushing the inflation rate up even further.[4]

Whenever inflation rises due to printing money, the private sector has an increasingly strong incentive to reduce the need to hold currency. For example, firms

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[4]Another problem with inflation can emerge when a government fixes the value of a country's exchange rate in terms of a foreign currency. Such a fix offers the benefit of stable prices for imported goods, but relies on the government having sufficient foreign currency reserves to maintain it. With high or even moderate inflation, foreign buyers of the country's goods will find that those goods—at the fixed exchange rate—are more expensive than goods from other countries. The consequent decline in exports is often associated with reduced employment and lower household income, and may cause the central bank to lose substantial foreign currency reserves. In some instances, specific exchange rate arrangements (such as a currency board) may help avoid or alleviate these problems, but are only likely to be successful if other conditions for overall macroeconomic stability are also in place.

may start sending their extra cash to the bank multiple times per day instead of waiting until just before closing time. With declining demand for currency, the government must print money at an even faster rate in order to finance the public deficit. The situation is roughly similar to that of a municipality with a shrinking tax base; in such a situation, raising the tax rate will generate a temporary rise in revenue but will subsequently cause even further shrinkage of the tax base.

Given these factors, an economy with ongoing high inflation faces substantial risk of sliding into an inflationary spiral referred to as "hyperinflation," with even more severe consequences for the poor. At the worst point of such a crisis, inflation can peak at over 100 percent per month, with annual inflation exceeding 1000 percent. As inflation reaches these levels, prices may be adjusted on an hourly basis, so that working families have trouble maintaining their standard of living even if wages are paid out once a day, while those on fixed incomes face a seemingly-hopeless situation. Such an episode occurred in Argentina in 1989: as consumer inflation rose to more than 3000 percent, the fraction of the population living below the official poverty line reached an all-time high.

Unfortunately, the only known cure for hyperinflation is to balance the government's budget deficit in conjunction with stabilizing the supply of money. With a depressed level of tax revenue, this prescription may require the government to make drastic cuts in public spending, at least temporarily, with correspondingly adverse effects on low-income households. Having eliminated the budget deficit, the government can then bring the printing press to a virtual halt. As the supply of currency begins to grow at

a much lower rate, inflation typically falls very sharply. Nevertheless, ongoing fiscal prudence is required to ensure that inflation remains at a fairly low and stable level.[5]

Scenario #3: Financial Crisis. The Asian financial crisis of 1997-98 demonstrates that sound fiscal and monetary policies are not sufficient to ensure macroeconomic stability: over the previous few years, nearly all the countries in this region maintained balanced budgets or even surpluses, while inflation remained low and stable. Thus, we now consider the extent to which the banking system can become the Achilles heel of the economy.

In almost all countries the banking system operates on a fractional-reserve basis. Each bank only keeps a small fraction of its deposits on reserve (either in the vault or at the central bank), and uses the rest of the money to finance business investment, property mortgages, and other types of bank loans. In normal circumstances, a moderate quantity of funds will be withdrawn from the bank on any given date, and this amount will be largely offset by new deposits of other customers and by repayment of existing loans. If any residual shortfall needs to be covered, the bank simply borrows on a short-term basis from some other bank that has excess reserves. In most countries, the government also provides some degree of explicit or implicit deposit guarantees; that is, if a given bank becomes insolvent, the government will pay off the depositors using funds generated by deposit insurance fees from other banks.

In a fractional-reserve banking system with a deposit insurance mechanism, each individual bank has an inherent incentive to shift its lending towards relatively high-risk projects for which the borrower is willing to pay a relatively high interest rate. If most of the projects in the bank's portfolio turn out to be successful, then the owners of the bank

[5] Fischer (2004) surveys the economics research showing the high cost of inflation on the poor.

receive a relatively high rate of return. And if too many borrowers default on their loans, then the owners of the bank simply walk away, the bank is closed down, and the government pays off the depositors. Given these incentive problems, government supervision and regulation is essential to ensure that the banking system maintains sound lending practices.

Unfortunately, oversight of the banking system has been insufficient in many cases, not only in developing countries but in some industrial economies (as shown by the U.S. savings and loan crisis of the 1980s and the protracted Japanese banking problems of the following decade). In such circumstances, financial institutions engage in an excessive amount of high-risk lending. As long as the economy continues to boom, these banks earn high rates of profit. But when the economy begins to slow, a greater fraction of high-risk projects tend to fail; if these borrowers cannot make the required interest payments, their loans are reclassified as "non-performing" or written off entirely.

Such imprudent lending problems can threaten the entire banking system, including banks with sound loan portfolios. At an early stage, a few specific banks may go out of business, and the deposits from those institutions are simply shifted to other banks. However, as the public becomes increasingly aware of the ongoing deterioration of banks' balance sheets, many depositors may decide to completely withdraw their money from the banking system, perhaps even moving the money out of the country altogether.[6] As a result, even more banks become unable to meet the demands of their depositors and must close their doors. (An excellent illustration of such an episode may be found in the classic movie, "It's a Wonderful Life.")

As the financial crisis evolves, the government is faced with taking over an increasing number of failing banks. If the banking system has been subject to inadequate regulation, then the value of loans of failed institutions may fall far short of the value of deposits. Thus, a banking crisis may cause the government to incur very large obligations quite rapidly, and it must come up with funds either by issuing new debt or by printing currency. In favorable circumstances, the government might obtain funds by issuing new debt at moderate interest rates (as in the resolution of the U.S. savings and loan crisis). But in other settings, as in the Asian crisis of 1997-98, the cost of rescuing the banking system may be so large as to push the government into a debt crisis (Scenario #1) or skyrocketing inflation (Scenario #2).

In either case, the financial crisis will tend to have serious consequences for poverty reduction and economic development. There will inevitably have been some disruption in bank lending, with firms running short of working capital and, along with households, losing access—at least temporarily—to their bank accounts. So it is hard to navigate a financial crisis without a fall in incomes and a rise in unemployment, which hurt the poor directly.

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[6] In many countries , the government maintains a system of deposit insurance oriented towards maintaining public confidence in the banking system; such arrangements have been reasonable successful in many industrial economies but less so in the developing countries.

Macroecomic Stability and the Poor

Several common threads are apparent across these scenarios that are relevant for thinking about poverty reduction. First, macroeconomic instability, by its very nature, hurts the poor. The high inflation and economic disruptions (such as slow or negative income growth, job loss, and breakdowns in the banking system) that occur with instability all harm the poor. This implies that macroeconomic stability—steady growth, low inflation, and no crises in the financial system—benefits the poor and is a worthy aim for economic policy makers even if looked at in terms of nothing but its effect on the poor.[7]

Second, once instability emerges some kind of stabilization policies are inevitable. The damage caused by crises is so large that governments must act. In each of the scenarios above, acting sooner rather is preferable to acting later in that the disruptions caused by instability are less pronounced and smaller adjustments are necessary to achieve stabilization.

Finally, the kinds of stabilization policies appropriate to the various scenarios are similar. Moving a country out of macroeconomic crisis almost always will require some mix of the following "stabilization" policies: adjustments in monetary policy that stabilize the inflation rate; measures to balance the government budget (including tax increases, spending cuts, and privatization of state-owned firms); and policies that stimulate exports and generate foreign exchange to make payments to creditors (including exchange rate adjustment and trade liberalization).

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[7] There are other important arguments in favor of stabilization, not the least of which is that it is almost always a precondition for economic growth and long-term improvements in the material wellbeing of the poor (see Fischer, Sahay and Végh, 2002). But the point we stress here, that economic instability in and of itself hurts the poor, can be lost in hectic public discourse during economic crises.

However, stabilization policies may themselves harm the poor. Is this avoidable, even if stabilization itself is unavoidable? What can be said about the best stabilization policy choices to achieve macroeconomic stability that minimize the harm suffered by the poor? We consider these important questions below.

Attaining Macroeconomic Stability—Long Run Issues

Although there is no simple recipe for ensuring macroeconomic stability, certain essential elements can be identified. It is helpful to distinguish between long-term and short-term factors, and we begin with the long-term.

First, the existing evidence supports the notion that a stable democratic political system is conducive to macroeconomic stability and long-term growth. While an authoritarian state may appear to be stable over some length of time, longer-term political stability requires the establishment of a representative democracy with guaranteed rights for minority groups. And an independent judicial system is needed to ensure that the political system remains representative and that minority rights are protected.[8]

Second, certain principles of sound fiscal policy are conducive to minimizing the risk of excessive budget deficits that might lead to a debt crisis (*Scenario #1*). Pressures for excessive military spending may be reduced by ensuring that the armed forces operate under the ultimate supervision of civilian authorities. Privatization of state-owned enterprises may be expected to alleviate pressures for excessive government payrolls as well as tendencies to provide subsidized goods and services to middle-class and high-income households. The tax system should be relatively simple and readily enforceable,

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[8] See, for instance, Barro (1991).

with very few exemptions for specific companies or individuals. For example, a value-added tax is largely self-enforcing: since each firm pays tax on its revenue less its costs of materials, the firm has a strong incentive to provide accurate information about its payments for raw materials and other inputs, which in turn enables the tax agency to determine the revenue of the firm which supplied those materials.

Third, certain principles of sound monetary policy help avoid high inflation and minimize the risk of hyperinflation (*Scenario #2*). In particular, the central bank should operate as an independent government agency, insulated from short-term political pressures. Monetary policy should be oriented towards a clear objective of low and stable inflation, so that the printing press is not used to finance ongoing budget deficits.

Finally, government oversight of the banking system is essential to avoiding a financial crisis (*Scenario #3*). Thus, sufficient resources need to be devoted to enable the banking supervisory agency to perform its functions effectively. More broadly, the government must ensure that the entire private sector is subject to transparent accounting standards, which in turn serve to facilitate the proper functioning of the banking system as well as other financial markets.

These policy prerequisites for long-term macro stability are not generally controversial, though implementing them can be difficult. Key elements on this list (such as central bank independence, and the ability to regulate financial markets) reflect institutional capabilities and reforms that may take years to accomplish.

Attaining Macroeconomic Stability—Short Run Issues

What are controversial are the particular policies countries use to achieve stabilization when they are in crisis, under pressure from international lenders, and anxious to stabilize quickly. As noted above, budget cuts, tax increases, privatization, currency devaluation and trade liberalization are the policies on the menu for rapid implementation when countries need immediate fixes. They are not unrelated to the long-run policies discussed above. For instance, privatization of a money-losing national airline is probably in line with long-term healthy fiscal practice. Balancing the budget, even on an emergency basis, opens a window for sound monetary policy management over the long-run. Currency devaluation may be essential for rebuilding foreign exchange reserves and attracting capital inflows. Trade liberalization can stimulate long-term growth and job creation among low-skilled workers.

But all of these policies may hurt the poor, at least in the short run, and often do. Tax increases may fall disproportionately on the poor. Government spending cuts may slash programs that especially helped the poor and women and children. Privatization may result in higher unemployment. Currency devaluation, which makes all imports more expensive, drives up the cost of staple items such as cooking fuel oil on which the poor depend. Trade liberalization takes time to deliver extra jobs in exporting sectors of the economy, while causing immediate suffering in industries that lose trade protection. NGOs and other observers have offered these points, among others, in criticism of stabilization policies.

There is some ambiguity about exactly how much harm occurs. Many studies show that the poor are worse off after the imposition of stabilization policies than before.

Unfortunately, it is often difficult to ascertain whether these adverse effects should be attributed to the stabilization policies or to the preceding instability.[9] Some studies that attempt to separate out the effects of the instability and the subsequent policy find that the poor may not be as harmed in the short term as commonly supposed. For instance, Sahn *et al*'s (1997) analysis of stabilization in 10 countries in sub-Saharan Africa in the 1980s and early 1990s found that education spending was so highly tilted towards the middle and upper classes that when governments cut education spending in fiscal retrenchments the effect on the poor was negligible. They also found that devaluations improved the poor's access to foreign exchange: on paper, devaluations implied higher prices for imported items, but prior to devaluation the shortage of foreign currency kept certain goods from the poor entirely.[10] But these findings do not generalize to all stabilization cases. A definitive universal answer to the question "does stabilization hurt the poor?" will probably remain elusive because it hinges on exact details of implementation and institutions that vary from case to case.

And, fortunately, fruitful collaboration between economists and practitioners need not await a definitive answer to that question. Given that stabilization policies of some kind are inevitable once macroeconomic instability emerges, and given that stabilization hurts at least some of the poor in the short and medium terms, practitioners and economists alike should give serious consideration to finding ways to prevent the costs of adjustment from falling heavily on the poor. Surely there are potentially fruitful grounds

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[9]See Sahn *et al* (1997, pp. 10-11) on this point, and for an excellent survey of the methodological issues involved in evaluating the effects of stabilization policies.

[10]The "cross-cutting" nature of stabilization policies' impacts on poor households also makes it hard to assess their overall effect on wellbeing. For instance, a household may lose access to a particular government health program when benefits are cut. But if inflation stops and household's adults have steadier jobs due to the resumption of growth, they may not be worse off overall.

for collaboration and study in this area of designing suitably targeted social safety programs. What might be involved?

First, it is helpful to recognize that the effects of stabilization on the poor are not uniform. While the economic policy changes inherent in stabilization often create a distinct group of "losers," other groups of poor households may gain. This means that the effort to create compensatory policies should be directed towards those groups among the poor who most need the help without compromising the gains made elsewhere.

A vivid example of this is seen in the case of Filipino vegetable growers in the temperate mountains of northern Luzon. They have suffered from dramatically lower prices for the vegetables, such as carrots, that they supply to urban dwellers now that the Philippines has liberalized its agricultural trade and Chinese carrots flood the market.[11] Yet, because the Philippines is a net importer of these vegetables, the real income gains to the urban poor of cheaper vegetables almost certainly exceeds poor farmers' losses. The appropriate policy response should be a targeted one that focuses on these small vegetable farmers rather than, say, a national-level response in trade policy that helps farmers by undoing a real gain for the urban poor. Careful analysis of who among the poor most needs help, and who does not, is essential for constructing the best social safety net policies.

Second, creating properly-targeted social safety nets is an enormous challenge. It is not at all clear what works best. Means tested programs (common in the west) are of limited use in developing countries because of their complex bureaucratic requirements. Current thinking focuses on labor intensive employment programs, which can be located precisely where need is great, and which attract precisely those most in need of help

(namely, those for whom low-paying but guaranteed work is superior to other options). Sometimes cash transfer programs are used in which participants are chosen in some way other than means testing. But in each of these types of programs the overall outcome can hinge on details of program design.[12]

All these considerations mean that NGOs and practitioners, with their well-developed grassroots capabilities and their international connections, could play a vital role in program study, design, and diffusion of knowledge about successful strategies. Best practice social safety net programs will not emerge without a large investment in study and design. The depth of this challenge suggests that there is much room for vigorous NGO action.

Conclusion

What lessons do we draw from this overview? Macroeconomic instability can have severe consequences for the poor, a key fact that should condition economist, NGO and practitioner response to stabilization policies. In an environment of democratic governance, long-term stability can be achieved by an appropriate mix of institutions and policies, including an independent central bank, a broad and equitable tax system, and effective supervision and regulation of the financial system.

Once macroeconomic crises emerge, stabilization policies are inevitable. Even though well-designed stabilization policies should bring substantial long-term benefits to the poor, they may harm the poor in the short-run. Evaluating stabilization policies'

[11] See Linder-Hess (2003) for a sympathetic account of the plight of the farmers near Baguio City.
[12] Schaffner (2005) discusses theoretical and practical issues in safety net program design.

effects on the poor requires distinguishing between particular groups among the poor, who may fare quite differently.

Macroeconomic stabilization by its very nature requires national-level policies that have different effects on different groups. National governments face difficult but unavoidable decisions about tradeoffs between present costs and future benefits, and about which sectors and groups in the economy will gain and lose in the short run. Targeted social programs are essential for helping the poor during stabilization while simultaneously allowing a government to pursue stabilization's long term benefits for everyone. But creating safety nets is inherently difficult. NGOs can be instrumental in helping to design the best such programs, as their knowledge and grassroots level experience offer essential insights.

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