

# Human Poverty and the MDGs: The Implications for Economic Policies

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## The Human Poverty Perspective

This paper starts with the concept of human poverty and its (implicit) translation into the Millennium Development Goal framework. But it concentrates on some of the implications of this framework for development-oriented economic policies. It also seeks to place these policies within the context of current global trends in resource transfers. Some of the biggest debates emerging on the MDGs are focused on pro-growth as well as pro-poor economic policies and the critical need for domestic resource mobilization and capital accumulation.

In the 1996 global *Human Development Report*, UNDP first introduced a multi-dimensional index of human deprivation. It was called the Capability Poverty Measure, a simple composite index based on the arithmetic mean of three indicators. These were the percentage of under-five children who are underweight, the percentage of adult women who are illiterate and the percentage of births unattended by trained health personnel.

It was the first index that strove to capture the ‘deprivation perspective’ for human development, as it has been called by Sudhir Anand and Amartya Sen (Anand and Sen 1997). It sought to pose an alternative to income poverty, by daring to posit—and then specifying—deprivational thresholds for dimensions of human development.

In the 1997 global *Human Development Report*, this measure was converted into the Human Poverty Index, in order to achieve alignment with the Human Development Index. It retained three dimensions of deprivation—in this case, those corresponding to the HDI. These are survival deprivation, deprivation of education and knowledge, and economic deprivation. The last dimension, which is the most difficult to capture, required three indicators; the other two dimensions required only one apiece.

So, practitioners acquired an operational alternative to income poverty. In fact, income poverty could be subsumed under human poverty as a manifestation of ‘economic deprivation’. But what is the problem with deprivation expressed as lack of income (or expenditures)? It is twice removed from human deprivation. Ideally, indicators of human poverty should gauge ‘capability shortfalls’ or inadequacies in ‘functionings’ (to use Sen’s terms).

Failing that, indicators can seek to indirectly reflect such deprivation by capturing the lack of access to *the means to support human capabilities*, such as water, sanitation or health services. These are the *direct inputs* into human development. But income is, itself, the means to finance such direct inputs, namely, to finance the public and private provisioning of necessities. Thus, it is not even a direct input into human development; it is an ‘aggregate means’ to the various direct inputs.

If we define deprivation in the space of ‘capabilities’ or ‘functionings’, then how many essential dimensions of deprivation should we posit? And is there a hierarchy of essential dimensions? Capability poverty occurs when people are unable to reach a certain minimally acceptable level of essential human achievement or ‘functioning’ (McKinley 1997). This paper takes the view that “human deprivations should not be

defined in terms of all important capabilities, but only essential or ‘foundational’ capabilities” (Ibid., p.2). Such deprivations could include “being malnourished, illiterate, in ill health from a preventable disease or experiencing physical hardship because of inadequate shelter” (Ibid., pp. 2-3).

But an ‘acceptable or foundational’ level of human functioning is still subject to normative judgment, and thus can differ by society. As Anand and Sen have remarked, “Issues of poverty in the developing countries crucially involve such matters as hunger, illiteracy, epidemics, lack of health service or of safe water...Not surprisingly, studies of poverty in the more affluent countries have tended to concentrate on other variables, such as social exclusion, or inability to take part in the life of the community” (Ibid. pp. 6-7). The latter dimensions of human poverty are more difficult to define and capture in indicators—and more difficult to link to policies.

For policy purposes, we invariably need to limit the number of dimensions of human deprivation and choose the ones that are most important and most well defined. There is a powerful moral imperative under-girding the study of poverty that compels us to action against such stark forms of social injustice. Purely academic pursuits pull us in the opposite direction, making poverty progressively more complex and more complicated. The inherent multi-dimensionality of human poverty lends itself easily to such a complex pursuit.

This paper assumes that being able to function on the basis of essential human capabilities is an objective, observable phenomenon; it is not a matter of subjective perception, nor is it culturally specific. The paper assumes that there is an absolute core to human deprivation, around which a universal consensus can be solidified. However, such initial simplicity of perspective does not allow us to avoid all complexity.

Since human beings function as ‘integrated wholes’, it is not always easy, for analytical purposes, to disaggregate their well being into separable ‘capabilities’ and ‘functionings’. The human poverty perspective is very much an outcome-oriented approach: we are searching for barometers of improvement in the basic quality of people’s lives. “It is ultimately in the poverty of the lives that people can lead that poverty manifests itself” (Anand and Sen, p. 5). But, in practice, it can be difficult to identify a particular outcome with the lack of a particular capability or functioning. For example, the manifestations of undernourishment and ill health often go together and their underlying causes can interact.

This implies that we often have to fall back on identifying the lack of external means to human well being as manifestations of deprivation instead of direct, observable deficiencies in capabilities or functionings. This is not an intractable problem since these means—e.g., lack of access to food, water or health services—often have a clear link to public policies.

An additional problem is that even if we assume that basic capabilities do not vary by society, the means to form and maintain them can indeed vary. For example, while undernourishment can be measured in the same way in different societies (such as in terms of stunting or wasting), the types of food consumed and their relative costs can vary widely. So, even if the basic objectives remain the same, the nature and scale of public investment to address human poverty is likely to differ across countries.

We now address the relationship between the human poverty approach and the Millennium Development Goal perspective. The MDGs provide a common international

framework for monitoring and evaluating development progress, and progress against human poverty in particular. We focus on the relationship between the two perspectives and the policy implications of this relationship.

### **The MDG Framework**

This paper takes the view that the Millennium Development Goal framework embodies, implicitly, a human poverty approach. Goal #1 (namely, halving extreme income poverty and hunger by 2015) is expressed in poverty terms. But many of the other goals, and their corresponding targets and indicators, can be directly related to various dimensions of human poverty.

Such targets include ensuring that all boys and girls complete primary school, reducing by two thirds the under-five mortality rate, reducing by three quarters the maternal mortality ratio, halting and reversing the spread of HIV/AIDs, malaria and tuberculosis, and halving the proportion of people without sustainable access to safe drinking water and sanitation.

Some of the corresponding indicators are expressed as “deprivation thresholds”, such as the prevalence of underweight children under five years of age, the prevalence of malaria, the literacy rate (or illiteracy rate) of 15-24 year olds and the proportion of the population living on less than one US dollar a day. Other indicators are expressed in more extreme forms, such as the under-five mortality rate or death rates associated with malaria or tuberculosis.

A third category of MDG indicators reflects the lack of means to prevent human poverty, such as the proportion of births attended by skilled health personnel, the proportion of one year-olds immunized against measles, the proportion of the population without access to improved sanitation or the proportion of the population using solid fuels.

A fourth category of MDG indicators merges concepts of human poverty and basic equity. Such indicators include the share of the poorest quintile in national consumption or the ratio of girls to boys in primary, secondary and tertiary education. The first indicator is a measure of relative poverty (i.e., a form of inequality). The second is a measure of equity among population groups, which extends beyond gauging human poverty (incorporating concerns, for example, with access to tertiary education).

Despite the variety of MDG targets and indicators, in most cases there is a clearly identifiable connection between the forms of deprivation (or lack of equity) and public policies and investment. And the targets are crafted as a means to measure and monitor the impact of public policies and investment.

Complications arise because of synergies among the efforts to achieve individual targets. The achievement of one target can be helped by the achievement of another or one target can be achieved by efforts along multiple dimensions. For example, reducing gender inequality in education can help reduce the prevalence of HIV/AIDs. Or the under-five mortality rate can be achieved through the multiple efforts of improving nutrition, broadening access to clean water or increasing birth spacing.

In most cases, such synergies do not obfuscate the relationship between public interventions and the reduction of human deprivation. But within the context of constrained public budgets, they can lead to more weight being attached to some interventions than others. Most importantly, such synergies underline the need for

integrated public investment strategies that rely on “complementary and mutually reinforcing interventions” (U.N. Millennium Project 2005, p. 94). Integrated strategies are more feasible, and cost-effective, than a collection of separate sectoral initiatives. This is one of the major policy conclusions derivable from the MDG framework.

Integrated public investment programmes geared to long-term development goals can build public momentum for more ambitious strategies and the concomitant scaling up of development resources. But in order to sustain such momentum politically, it is necessary to translate 2015 targets into short-term targets achievable by current governments during their tenure in office. This would imply intermediate targets associated with such concrete initiatives as distributing bed nets, training teachers or treating AIDS patients (Vandemoortele 2005). In many cases, the indicators for such targets would identify the extent of inputs into human well being instead of the quality of outcomes. This would imply, fortunately, a tighter fit in the short term between monitoring of indicators and the implementation of policies.

This point emphasizes the need for constant monitoring of progress against human poverty. And this underlines, in turn, the need for clearly defined, practical and transparent indicators. “Statistics not only document progress but also mobilize people and help design pro-poor policies based on hard evidence—not only on economic theory. Monitoring must use a few easy-to-grasp indicators” (Ibid. p.2).

In conclusion to this section, this paper argues that for policymaking purposes, as well for political economy reasons, the dimensions of human poverty targeted for action should be limited to an essential ‘absolutist’ core. They should also be well defined, translatable into indicators and monitorable. Most importantly, they should be clearly linked to policies, either in terms of tracking outcomes of, or gauging inputs into, human well being. Many of the indicators used for the Millennium Development Goals fit these criteria. Taken together, they provide a reasonably comprehensive and operational framework for charting progress against human poverty.

### **The MDGs, Economic Policies and Growth**

But what are the major obstacles to implementing policies that are aligned with the MDG framework? This paper concentrates on pro-poor and pro-growth economic policies and the scope for mobilizing development resources that can finance extensive MDG-related public investment programmes. It argues that several key tenets of Neoliberal economics need to be combatted before national policymaking can be re-oriented towards implementing MDG-based strategies.

The general points that follow draw on 25 UNDP-supported country studies and several regional programmes on Economic Policies for Growth, Employment and Poverty Reduction. These studies have critically examined macroeconomic policies (fiscal, monetary and exchange-rate policies) and adjustment policies (financial liberalization, trade liberalization and privatization). This paper concentrates on fiscal, monetary and financial policies and their impact on savings, investment and capital accumulation. Our conclusions concur, to some extent, with those of a recent World Bank assessment of trends in economic growth among developing countries, *Economic Growth in the 1990s: Learning from a Decade of Reform* (World Bank 2005b).

In the 1990s, economic policies were focused on macroeconomic stabilization. In practice, this often meant concentrating on achieving price stability. But macroeconomic

stabilization has not proven to be a sufficient condition for stimulating economic growth. In many countries, moreover, macro stability has been pursued at the expense of growth-enhancing policies, such as increased investment in economic and social infrastructure (World Bank 2005b, p. 109). Thus, fiscal adjustment has often had a distinct anti-investment bias. In this light, “some economies may well have been overstabilized...[and]...the growth payoff of macroeconomic stability may have been oversold” (World Bank 2005b, pp. 109-110). Nevertheless, there is no denying that some progress have been registered.

Since the 1990s, policies of macroeconomic stabilization have been relatively successful, on average. Budget deficits have been reduced or turned into surpluses, currencies have been depreciated and stabilized and inflation has been markedly reduced. However, it is now widely recognized that small deficits, stable exchange rates and low inflation are not sufficient conditions for initiating a sustained growth dynamic. Capital accumulation does not happen automatically thereafter.

Moreover, the record of stabilization since the 1990s remains mixed (World Bank 2005b). While the average volatility of GDP in developing countries declined in the 1990s, in about one third of the countries volatility worsened compared to the 1980s. The general incidence of extreme volatility, in fact, increased. In addition, real exchange rates remained highly volatile in low-income countries and exchange-rate collapses were numerous.

What has been the payoff to the focus on macroeconomic stabilization? Simplifying, it has been relatively modest increases in growth along with a series of debilitating financial crises. Economic reforms have been remarkably unsuccessful in addressing fragilities in the financial sector, whose effects have been compounded by complete capital-account convertibility. This has had a debilitating impact on the ability of developing countries to mobilize domestic savings, retain it and direct it to productive private investment. This is one major reason that the record of growth has been lackluster.

As comprehensive as economic reforms (and conditionalities) have been, they have not added up, for most developing countries, to coherent strategies of broad-based economic growth. It has usually been the countries, such as China, India and Vietnam, which have explicitly not followed Neoliberal orthodoxy that have succeeded in sustaining rapid rates of growth. But this has customarily involved more pro-active state intervention to ensure that domestic development finance is effectively mobilized and placed at the disposal of both public and private investment.

The result has been impressive strategies of rapid capital accumulation, based on savings and investment rates that have been both high and mutually reinforcing. Based on such capital accumulation, these countries have been able to incorporate, if not generate, technological innovation. Unfortunately, purely market-led processes are unlikely to have produced such marked successes.

An additional feature common among most of the countries that have succeeded in accelerating and sustaining growth is that its benefits have been broadly shared (World Bank 2005b; see also World Bank 2006 (forthcoming)). This has often been based on broadening access to economic opportunities, such as access to jobs, education, assets and technology. It is also noteworthy that the sustainability of the growth process has

often been linked to its equitable impact. Achieving greater equity, particularly in access to economic opportunities, can stimulate and reinforce growth.

## **Fashioning ‘MDG-Based’ Economic Policies**

### **A. Fiscal Policies**

At the center of MDG-based development strategies is investment, both public and private. Reaching the MDGs will require dramatic scaling up of public investment programmes in particular. And these efforts will need to be supplemented by increases in private investment. But much remains to be done to rehabilitate the role of public investment and clarify its relationship to private investment.<sup>1</sup>

The ‘anti-state’ Neoliberal bias in recent economic thinking has led to the widespread fear that increases in public investment will invariably ‘crowd-out’ or supplant private investment. The relentless attacks on any state-led development strategies have given public investment a bad name. Beginning in the 1980s, structural adjustment programmes have accelerated the general decline in public investment in developing countries (World Bank 2005b, p. 104). When fiscal crises have hit, public investment has often been the first victim of cutbacks. The emergency concerns to protect current welfare have trumped considerations for future welfare; macroeconomic stabilization has taken precedence over investments for long-term growth.

As a result, in most regions, there has been a secular decline, or stagnation, in public investment since the 1970s (Table 1). Only in East Asia and the Pacific has there been a steady increase in public investment, measured as a percentage of GDP. While public investment has edged up South Asia, the increase has been very small and the level remains low. In other regions, such as Latin America and the Caribbean, the Middle East and North Africa, and sub-Saharan Africa there has been a marked decline since the 1970s.

**Table 1. Public Investment Trends by Region  
(Per cent of GDP)**

<b>Region</b>	<b>1970s</b>	<b>1980s</b>	<b>1990s</b>
<b>East Asia &amp; Pacific</b>	3.4	3.9	4.1
<b>Latin America &amp; Caribbean</b>	4.0	2.7	2.8
<b>Middle East &amp; North Africa</b>	11.7	9.2	6.8
<b>South Asia</b>	2.4	2.5	2.6
<b>Sub-Saharan Africa</b>	4.7	3.6	3.3

Source: Levine 2005. Note: The table captures central government capital expenditure

The decline in public investment in low-income countries, such as in Africa, is particularly unfortunate. It is in these countries that public investment is most needed and, as a ratio to GDP, should be the highest.<sup>2</sup> In poorer countries, public investment

<sup>1</sup> Much of this section on “Fashioning ‘MDG-Based’ Economic Policies” draws heavily on McKinley 2003 and McKinley 2005d.

<sup>2</sup> As a ratio to GDP, public investment tends to decline as a country’s income level rises.

programmes should be substantially augmented in order to broaden access to essential public services and infrastructure. Moreover, because of declines in public investment as a result of fiscal austerity, much of the public capital stock in these countries is now worn out and in disrepair.

Broad-based public investment programmes are essential in such countries for accelerating progress against human poverty, or reversing calamitous increases, such as caused by the HIV/AIDS epidemic. But there is also a compelling economic case for promoting public investment.

In such economies, where public capital is already scarce and economy-wide capacity is under-utilized, there is little danger that public investment will ‘crowd-out’ private investment. In fact, the reverse should be the case. Such investment should stimulate private investment and economic growth. As we have learned from past experience, this will depend, of course, on the design of public investment programmes. What is crucial is that public investment should contribute to the productivity of labour and capital. Vital economic infrastructure, such as roads, electricity and irrigation works, is likely to have such an impact. Social infrastructure, such as education and health facilities, will also have a positive economic impact although with a greater lag.

Most recent studies of the relationship between public and private investment have found a positive relationship. A recent UNDP-supported paper (Levine 2005) has regressed private investment on public investment (lagged by one year) for 511 observations from 41 developing countries covering the period 1980-1999. Domestic savings and growth rates were also independent variables in the estimation. The parameter for public investment was 0.18 and was statistically significant (as were savings and growth).

This implies that a one point increase in the percentage of GDP represented by central government capital expenditure was associated, the following year, with a 0.18 point increase in the percentage of GDP represented by private fixed investment. This result supports the hypothesis of ‘crowding-in’. As should be expected, the results are strongest for low-income developing countries, where public investment is sorely lacking.

An additional reason for maintaining that public investment is likely to have a positive impact on private investment is derived from recent research findings that achieving greater equity in economic opportunities can often contribute to more rapid rates of growth. Not only does greater equity provide direct benefits to the poor but it also enhances the prospects for aggregate long-term development (World Bank 2006, p.2). In other words, in the long run, there need be no inherent trade-off between growth and greater equity.

Broad-based public investments in economic and social infrastructure (such as those envisaged by “Investing in Development”, the report of the U.N. Millennium Project) will help overcome many of the market failures common in developing countries that have hampered basic human development. Either these market failures have to be corrected or some forms of redistribution have to be carried out to correct these conditions.

A corollary of this finding is that if greater equity can promote long-term development, then public interventions to secure such equity should be undertaken early in the development process (McKinley 2005c). Since an MDG-focused public investment

programme will make private investment more productive (by providing, for example, more public infrastructure and skilled workers), ‘front-loading’ such a programme will not only help accelerate economic growth but also ensure that its benefits are broadly shared early in the process rather than later. An early ‘big push’ to boost equity would imply that MDG-based strategies would need less total investment to halve extreme income poverty because resources would be focused both more effectively and sooner on poor households (McKinley 2005c and Kakwani and Son 2005).

## **B. Monetary Policies**

Investment-focused fiscal policies cannot be successful if their impact is neutralized by restrictive monetary policies. Inflation phobia has governed the implementation of monetary policies while the main objective of fiscal policies has been narrowed to containing budget deficits in order to support monetary policies. Monetary and fiscal policies need a role reversal, however.

More pro-growth fiscal policies, focused on dramatically augmented public investment, should set the development agenda and monetary policies should accommodate to such a fiscal stance. This implies that monetary policies should take a more flexible approach to inflation.

In recent years, global inflation has clearly been on the decline. From 1990-1994 to 2000-2003, global inflation dropped from about 30 per cent to almost four per cent (Rogoff 2003). Inflation in developing countries declined from a high point of about 53 per cent in 1990-1994 to a historically low level of under six per cent in 2000-2003 (Table 2). In Asia, inflation reached a low of about two per cent in the most recent period—an average close, in effect, to deflation.

**Table 2. CPI Inflation Rates (% per year)**

<b>Region</b>	<b>1980-84</b>	<b>1985-89</b>	<b>1990-94</b>	<b>1995-99</b>	<b>2000-03</b>
<b>World</b>	14.1	15.5	30.4	8.4	4.1
<b>Developing Countries</b>	31.4	48.0	53.2	13.1	5.7
<b>Africa</b>	16.8	17.9	39.8	20.6	11.8
<b>Asia</b>	9.0	11.5	10.5	7.3	2.3
<b>Latin America</b>	82.4	185.9	232.6	17.2	8.2
<b>Middle East</b>	18.6	22.5	30.4	29.6	16.4
<b>Transition Economies</b>	6.2	7.7	363.2	53.9	14.5

Source: Rogoff 2003

Demand-push inflation, based on an excessive growth in money supply, does not appear now to be a major problem in many developing economies. But the declining trend in inflation has only strengthened the tendency of Neoliberal economists to push further for ‘inflation targeting’ and the independence of central banks as a precondition for pursuing such policies.

Often, the stated ‘target’ of central banks is inflation rates in the range of 3-5 per cent per year. And the preferred tool to maintain such low rates is raising real rates of interest. In addition, central banks are judged on whether they achieve low inflation, not on whether they help promote growth, employment or poverty reduction. The theory behind such practices is that inflation is caused by excessive aggregate demand (fueled



by excessive growth of the money supply) and this is reinforced by expectations of continued high inflation in the future. So, in order to dampen such expectations, central banks publicly announce their intention to maintain low inflation rates for the foreseeable future.

Unfortunately for Neoliberals, there is little empirical support for maintaining inflation rates below five per cent per year. Instead, more moderate rates of inflation (conservatively estimated to be 5-15 per cent) have been found to correlate well with growth (Chowdhury 2004; Bruno and Easterly 1998). Some studies have found, in fact, no evidence for a negative effect of inflation on growth until inflation reaches 20-25 per cent (Bruno and Easterly 1998).

Even the in-house researchers of the IMF conclude that there is a negative impact of inflation on growth in developing countries only above the threshold of 11-12 per cent (Khan and Sendhadji 2001). Part of their explanation for this threshold, which is higher than for industrial countries, is that because governments in developing countries suffer from low tax revenue, they have to compensate by resorting to an inflation tax. So raising revenue in this way does not negatively affect growth as long as inflation remains below the threshold.

One of the main drawbacks of the inflation-targeting approach is that it subordinates fiscal policy to monetary policy. The main objective of fiscal policy is a limited one: constrain government deficits. Such an approach leaves little room for policymakers to achieve output stability, much less more rapid growth sparked by public investment.

Moreover, 'inflation-targeting' policies are particularly inept when inflation is exacerbated by cost factors, such as the rising price of imported oil. Inflation 'targeters' are fixated on only one policy response to such a problem: drive up the real interest rate. This causes either a recession or economic stagnation. As the global price of oil reaches new highs (now about US\$ 65 per barrel and threatening to increase further because of limited supply), Neoliberal monetary policies represent a dangerous nostrum. Widespread stagflation looms as the likeliest outcome if central bankers continue to pursue such options in the face of a supply shock.

In order to avoid wrenching recessions in developing countries as a result of a new oil crisis (based on a real, rather than an engineered, shortage), mechanisms will have to be devised in order to recycle the 'excess savings' of oil exporters to these countries. This recycling was carried out in the 1970s through international loans from commercial banks, and many developing countries piled up an unsustainably large external debt burden. As a result, a different mechanism, such as an ODA-based stabilization fund, will have to be devised if such a crisis breaks out again.

Like the current MDG framework, which advocates a substantial scaling up of ODA, such an approach would necessarily involve a large influx of external resources into developing countries. Neoliberals have already been quick to charge that such a large influx of ODA would cause a "Dutch Disease", i.e., an appreciation of a country's exchange rate and a consequent loss of international competitiveness. But the short-run effects of increased inflows on a country's exchange rate ignore the potential longer-run effects on expanding an economy's productive capacity if such resources are used to finance public and private investment.

In the short term, large inflows of aid will most likely raise the price level and appreciate the exchange rate principally by raising demand for non-tradable services and goods. The appreciation of the exchange rate signifies that the prices of non-tradables (e.g., food crops, construction work and public services) rise relative to the prices of tradables (e.g., items that are customarily exported, such as cash crops, and are imported, such as machinery). The competitiveness of a country's export sectors might suffer as the costs of their non-tradable inputs rise faster than the prices of their outputs on the world market (DfID 2002).

Over the medium term, the effect of such an inflow can be much more positive provided that it is used productively—and the higher level of inflows is sustained (DfID 2002). If aid is sustained, governments can then afford, in the short term, to 'sterilize' the increased inflow by selling some of the additional foreign exchange to the private sector or issuing domestic debt. Both of these measures decrease the money supply (by drawing domestic currency out of the private sector) and thereby relieve upward pressure on prices. However, governments that insist on maintaining inordinately low prices will tend to 'over-sterilize' (draw too much money out of the private sector) and undercut the potential for using aid to finance increased public investment and stimulate more private investment. Such sterilization will also short-circuit financial deepening since the money supply should grow faster than output to achieve this effect. These consequences are a clear and present danger for those governments wedded to strict 'inflation targeting'.

### **C. Financial Policies**

In most countries that have sustained rapid rates of growth, the state has invariably played a central role not only in financing essential public investment but also in ensuring necessary, if not and sufficient, conditions for the private accumulation of capital. Its development objective has been rapid, self-sustaining capital accumulation based on mobilizing domestic savings and deploying it for productive private and public investment. However, Neoliberal financial policies have largely failed to promote such conditions, or even recognize their central importance.

Although financial liberalization has been widely heralded, its impact on developing countries has generally been neither pro-growth nor pro-poor. Responding to liberalization, commercial banks have concentrated their activities in major urban areas. The rural population remains deprived of credit in most countries, and is likely worse off compared to the access to credit it had previously from state-owned agricultural banks.

One reason that growth is faltering in many developing countries is that access to long-term investment credit is severely limited. Commercial banks specialize in providing short-term, high-cost credit. They concentrate on lending for consumer durables for high-income households, working capital for enterprises or purchase of short-term, low-risk government securities.

Banks consider the risks to be too high to commit loans for long-term investment purposes. When they do, they lend to the few large corporations in urban areas that they consider creditworthy. In addition, they would rather reap the high returns from buying government T-bills and bonds, especially when such financial assets are risk-free. Or, if they are able, they commit their excess liquidity to buying foreign financial assets, which appear to be less risky than domestic assets.

Integrally related to the lack of credit in many developing countries is the high spread between deposit and lending rates of interest. In all low-income countries, this spread has widened from about eight per cent in 1990 to over 12 per cent in 2003 (Table 3). The trend is the same for sub-Saharan Africa. In fact, this spread has widened in all regions. In South Asia, it jumped from only 2.5 per cent in 1990 to over seven per cent in 2003 and even in East Asia it rose from two to five per cent.

**Table 3. Interest Rate Spreads, 1990 and 2003 (Percentage Points)**

<b>Grouping/Region</b>	<b>1990</b>	<b>2003</b>
<b>Sub-Saharan Africa</b>	8.2	12.4
<b>South Asia</b>	2.5	7.3
<b>East Asia &amp; the Pacific</b>	3.1	5.2
<b>Middle East &amp; N. Africa</b>	2.2	5.2
<b>Latin America &amp; Caribbean</b>	8.2	9.3
<b>Europe and the CIS</b>	--	6.5
<b>Low Income</b>	8.2	12.4
<b>Middle Income</b>	5.0	6.3

Source: World Bank, *World Development Indicators 2005*, Table 5.5

The large and widening spreads between deposit and lending rates of interest underscores why private investment has grown so slowly. Credit is either not available or too expensive for the private sector. In many instances, the private sector has even less access to investment credit after financial liberalization than before. These conditions are short-circuiting a more rapid accumulation of capital. Not only are banks having difficulty in mobilizing savings but also when they do have deposits at their disposal, they are reluctant to lend for long-term investment.

This implies that if developing countries are to accelerate economic growth, or even sustain the growth rates that they have already attained, major financial sector reforms focused on the mobilization of domestic savings and the financing of productive private investment are necessary. The state will have to intervene to apply regulations or provide incentives to commercial banks to supply more long-term loans. Options include loan guarantee schemes or differential asset-based reserve requirements. An alternative is to utilize development banks, which have historically had the function of providing long-term development-oriented loans, particularly in countries where the private banking system is underdeveloped.

Despite problems with investment, the most glaring constraint in poor countries is the lack of mobilization of domestic savings. In many of these countries, a sizeable share of gross domestic investment is financed by capital inflows, mainly official development assistance. As a consequence, gross domestic investment often exceeds gross domestic savings. The U.N. Millennium Project has highlighted a ‘savings trap’ as a binding constraint on development in the poor countries of sub-Saharan Africa (Sachs et al., 2004). Because income per person is so low, it argues that almost all of income is devoted to survival consumption.

Table 4 illustrates the problem of the lack of savings in low-income developing countries. Gross domestic savings is only about one fifth of GDP. If net current transfers are added to domestic income, then the savings rates rise for some poor regions, such as

South Asia. But for sub-Saharan Africa, net current transfers are negative so that its gross national savings is lower than its gross domestic savings. Once the depreciation of capital is taken into account, such as by *net* national savings, the level is much lower. For sub-Saharan Africa, the savings rate drops to an abysmally low level of six per cent of gross national income.

**Table 4. Savings Rates in Low-Income Countries**

<b>Grouping</b>	<b>Gross Domestic Savings (% of GDP) 2003</b>	<b>Gross National Savings (% of GNI) 2003</b>	<b>Net National Savings (% of GNI) 2003</b>
Low-Income Countries	20	23	14
South Asia	21	25	16
Sub-Saharan Africa	18	17	6

Source: World Bank, *World Development Indicators 2005*, Tables 3.15 & 4.5. Notes: GNS equals GDS plus net current transfers. NNS equals GNS minus the consumption of fixed capital.

### **The Dynamics of Global Savings and Investment**

Global flows of capital are working against poor countries. Savings are flowing into poor countries, but not by much. In low income countries, investment exceeds savings by three percentage points of GDP (Table 5). By contrast, both lower middle income and upper middle income developing countries save more than they invest, i.e., they export excess savings. Upper middle income countries export savings equivalent to five per cent of their GDP.

At the global level, gross savings should equal gross investment. So which countries are importing most of the excess savings that middle income developing countries are exporting? In aggregate, high income countries invest as much as they save. But certainly not all of them do so. Both Japan and the European Union export excess savings (in both cases about two per cent of their GDP).

**Table 5. Disparities in Gross Domestic Savings and Capital Formation  
(Per cent of GDP)**

<b>Country Grouping</b>	<b>Gross Investment 2003</b>	<b>Gross Savings 2003</b>	<b>Savings minus Investment 2003</b>
Low Income	23	20	-3
Lower Middle Income	28	30	+2
Upper Middle Income	19	24	+5
High Income	20	20	0
United States	18	14	-4
United Kingdom	16	13	-3
Japan	24	26	+2
Europe EMU	20	22	+2

Source: World Bank, *World Development Indicators 2005*, Table 4.9

The big importers are the United States and the United Kingdom. For example, the United States imports savings from the rest of the world that is equivalent to four per cent of its GDP. In absolute terms, this is an astoundingly high amount.

In 2003, the United States alone imported capital worth about US\$ 550 billion. The United Kingdom imported about US\$34 billion. What is astonishing is that the United States alone accounted for almost 72 per cent of global capital imports in 2003 (McKinley 2005b). This amount was about seven times higher than the total Official Development Assistance given by donor countries in that year, namely, about US\$ 77 billion.

Table 6 presents the top five capital importers and exporters in the world and their percentage of the total for each category. Japan accounted for over one fifth of capital exports in 2003. China (including Hong Kong SAR) accounted for almost one tenth. In addition to Japan, other rich countries, such as Germany and Switzerland, also contributed significantly to capital exports. Newly industrialized countries, such as the Republic of Korea and Singapore, have also been capital exporters.

Emerging economies and developing countries<sup>3</sup> exported capital worth close to US\$ 290 billion, or about 53 per cent of U.S. capital imports. In other words, these countries were exporting their savings instead of channeling it into domestic investment. Most of them are middle-income countries, many of them in Asia. Some of the capital exporters are transition economies, such as Russia; others are oil exporters, such as Saudi Arabia. For example, the differential in Saudi Arabia between savings and investment is huge—namely, about 20 percentage points of GDP. The disparity is also large for Developing Asia but China’s surplus savings looms large in this aggregate statistic. Nevertheless, surpluses in other Asian countries, such as Malaysia and Indonesia, also figure prominently.

**Table 6. The Top Five Major Exporters and Importers of Capital, 2003**

<b>Capital Exporting Countries</b>	<b>Percentage of Total Capital Exports</b>	<b>Capital Importing Countries</b>	<b>Percentage of Total Capital Imports</b>
Japan	20.5	United States	71.5
China*	9.4	United Kingdom	4.1
Germany	7.8	Australia	4.1
Switzerland	6.4	Spain	3.2
Russia	5.3	Italy	3.0

Source: IMF, 2005b, p. 147. \* China includes Hong Kong SAR.

The aggregate picture that Tables 5 and 6 paint is that one rich country, the United States, is sucking up the great majority of all excess savings in the world. This implies that the excess savings being generated globally are not being recycled on any significant scale to poorer developing countries, such as in South Asia and sub-Saharan Africa, where savings are ‘deficient’. Thus, even when capital is generated by middle income developing countries or newly industrialized countries, it flows mostly ‘uphill’ to rich countries, not ‘downhill’ to poor developing countries (McKinley 2005a).

<sup>3</sup> This is an IMF category, which includes rich oil exporters, such as Saudi Arabia, and countries in transition, such as Russia.

The Millennium Development Goals campaign has been building public support for a doubling of Official Development Assistance. But compared to the absolute sums of financing involved in the transfer of resources to the United States and other rich countries, ODA can play, at most, only a limited redistributive role. Its main function will be in financing more extensive public-investment programmes in low-income countries in order to enable them to escape ‘poverty traps’.

The imbalances in savings and investment require significant changes in macroeconomic policies and development strategy in both middle income countries with large excess savings and rich countries with large deficit savings. For surplus countries, this will involve a shift in development strategy more towards augmenting domestic demand and boosting domestic incomes. For rich deficit countries, this will necessitate gradual—but substantial—fiscal contraction. This shift in the locus of both fiscal expansion and fiscal contraction will play a much larger role than ODA in redistributing global income. However, the likelihood that such a transition could be abrupt and chaotic is markedly increasing.

The economic position of the United States is unsustainable over the medium to long term (Izurietta 2005). Its level of consumption exceeds its own income by about five per cent. Almost one fifth of household income is already committed to servicing debt. Domestically, this level of consumption has been buoyed by the real estate and stock-market boom. Already, the stock-market boom has collapsed and the housing boom threatens to do the same.

Globally, the U.S. level of consumption is financed by the savings of other countries, whose governments and rich citizens continue to invest in U.S. public and corporate securities. Foreign net lending to the U.S. has reached about 16 per cent of U.S. disposable income and the stock of U.S. debt to the rest of the world has climbed to over 170 per cent of disposable income. These trends are problematic on their own. However, more storm clouds are gathering on the horizon.

### **The Impact of Rising Oil Prices**

Growth of the United States is bound to slow as the full impact of the emerging oil crisis hits its economy. The global demand for oil is beginning to outpace available supply. Although technology could be applied to expand supply, the room for maneuver is limited. Even if large new oil reserves are discovered and investment is mounted to exploit them, such developments will not ameliorate market conditions in the medium term.

OPEC, which still accounts for about 70 per cent of the global output of oil, is producing close to its current capacity. Within OPEC, much depends on current projections of Saudi oil. Its ‘proven’ reserves account for one fifth of the total (Table 7). But even this estimate remains a matter of conjecture. Moreover, in terms of total economic returns, OPEC might have already reached its optimal market share. While non-OPEC countries account for the other 30 per cent of global production they face more constraints in boosting their output levels. For example, although Canada accounts for 14 per cent of total proven reserves, this percentage includes non-conventional oil, which is more difficult to produce. Thus, the global oil market is likely to remain tight and vulnerable to shocks for the foreseeable future.

Global capacities are already being stretched to meet rising demand, with China contributing to the increase and other countries, such as India, on their way to doing so. One reason that demand has not yet plunged as a result of rising prices is that oil intensity has declined since the 1970s. Over the past 30 years, oil intensity (the use of oil per unit of output) has been halved in industrial countries and cut by one tenth in developing countries. But the dependence on oil is still substantial, particularly for transport vehicles.

On the demand side, much depends on how the United States responds to the crisis. It accounts for about one quarter of global demand for oil (Maass 2005, p. 35 and IMF 2005a). Together, the U.S., Europe and Japan account for a little over half of global consumption (Table 7). As China and India have grown, they have become significant consumers of oil. Although together they still account for only 11 per cent of total consumption, between 1990 and 2003 they accounted for 35 per cent of the incremental increase in consumption (IMF 2005ap. 158). As vehicle ownership spreads and industrial production expands in these two countries, their demand for oil is bound to accelerate.

**Table 7**  
**The Top Consumers of Oil, 2004**

	<b>United States</b>	<b>OECD Europe</b>	<b>China</b>	<b>Japan</b>	<b>Russia &amp; CIS</b>	<b>India</b>
<b>Percentage of Total Consumption</b>	<b>25</b>	<b>19</b>	<b>8</b>	<b>7</b>	<b>4</b>	<b>3</b>

**Countries with The Highest Proven Oil Reserves, end-2003**

	<b>Saudi Arabia</b>	<b>Canada*</b>	<b>Iran</b>	<b>Iraq</b>	<b>U.A.E.</b>	<b>Kuwait</b>
<b>Percentage of Total Reserves</b>	<b>20</b>	<b>14</b>	<b>10</b>	<b>9</b>	<b>8</b>	<b>8</b>

Source: IMF 2005a, Figure 4.2, p. 158 and Figure 4.4, p. 163. \* signifies that this includes non-conventional oil.

The relationship between oil prices and output tends to be nonlinear: while price increases can have a limited effect on demand for a while, if the price level becomes particularly high, consumer and business confidence can plummet. Although the price of oil is already high, if it continues to rise, the forces of stagflation could trigger a sharp contraction of the U.S. economy.

This is a necessary correction that national policymakers have been unwilling, on their own, to induce, even on a gradual basis. However, a rapid uncontrolled correction of the U.S.'s huge imbalances could have a destabilizing impact on world output. The U.S. economy is extremely vulnerable to an oil shock because it is already carrying a heavy external debt burden and the growth of its domestic consumption demand is highly reliant on borrowing and the real estate bubble. Raising real rates of interest in order to stem the inflationary pressures from rising oil prices could readily deflate the housing market bubble and exacerbate domestic and external debt burdens.

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