

ANNEX 3

PRSP Sourcebook: Does It Provide Adequate Space for Policy Flexibility, and Is It Based on Strong Empirical Evidence?

Policy Prescription in the PRSP Sourcebook ¹	Does the Policy Prescription Allow an Appropriate Degree of Flexibility in the Policy Space? ²	Is the Policy Prescription Well Supported by Empirical Evidence on the Links Between Policies and Growth or Poverty Reduction? ³
A. Macroeconomic stability		
1. Macroeconomic stability is necessary for growth. (12.2.2)	Yes (statements are very general).	Yes—but debates about what stability “thresholds” should be.
2. Macroeconomic instability hurts the poor – Inflation hurts the poor (a regressive tax) and, beyond certain thresholds, curbs output growth. (12.2.3) – Economic crises/instability have a longer-term adverse impact on poverty (e.g., through hysteresis effects). (12.2.3)	Yes (acknowledges substantial “gray area”). Yes.	Robust cross-country evidence is limited, but statements are quite contrary.
3. For countries where macroeconomic imbalances are not severe, a range of possible macroeconomic targets is consistent with the objective of stabilization. (12.2.5 and 12.3)	Yes.	Yes.
4. In adjusting to external shocks, since there is inevitable uncertainty about whether they are temporary or permanent, it is usually wise to assume that an adverse shock will persist. Countries in macroeconomic crisis typically have little choice but to stabilize quickly, but for countries in gray area of partial stability, finding the right pace may prove difficult. In some cases, a lack of financing will drive the pace of stabilization. (12.3.2)	Partial (overly prescriptive on how to respond to shocks).	Too country-specific to generalize.
5. In some cases, lack of financing will drive the pace of stabilization. Where financing is not a constraint, policy makers will need to weigh various factors on a case-by-case basis when choosing the most appropriate pace of stabilization. (12.3.3)	Yes—quite general, but acknowledges critical role of financing availability.	Yes.
B. Fiscal policy		
1. There are no rigid predetermined limits on what would be an appropriate fiscal deficit, which should be assessed on the basis of the medium-term outlook and the scope for external budgetary assistance. (12.4.1 and 12.4.2)	Yes.	
2. Governments can reduce the procyclical nature of their fiscal policies by saving the windfalls that follow positive shocks and using the savings as a buffer for expenditure against negative shocks. A cautious approach would be to treat every favorable shock as temporary and every adverse one as permanent.	No (too prescriptive on the fiscal policy response to shocks).	No.

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3. There is a strong case for allowing higher grants to translate into higher spending, to the extent that those grants can reasonably be expected to continue, but there may be absorptive constraints. In the absence of medium-term commitments, policymakers should be cautious in aid projections. (12.4.2)	Yes.	
4. Tax policy should move toward a system of easily administered taxes with broad bases and moderate marginal rates. (12.4.2 and Box 12.4)	No (the description of the contents of the “best tax systems” is quite detailed and does not discuss potential trade-offs).	Considerable case study experience on components of an effective tax system, but poverty effects of decisions on coverage etc. can be very country specific (e.g., Ethiopia PSIA of tax reforms).
5. Governments should take into account the extent to which public sector borrowing crowds out the private sector’s access to credit, but at times public sector borrowing can “crowd in” private investment by financing critical infrastructure. Domestic budgetary financing should take account of the relative productivity of public and private investment. (12.4.2)	Broadly yes—but no acknowledgment of risks that speed of response of private sector may be overstated.	
C. Monetary and exchange rate policies		
1. Set a single objective for monetary and exchange rate policy: the achievement of low and stable inflation (i.e., a single-digit rate, the precise target depending on a country’s inflation history and level of development). (12.4.3)	Broadly yes; single-digit threshold for inflation.	Yes—although there is some debate on the precise inflation threshold linked to good growth performance, and evidence on poverty links are less robust.
2. Credibility can sometimes be enhanced by imposing restrictions on policy (e.g., limiting the discretion of the monetary authorities, including through various nominal anchors) or by adopting specific institutional arrangements. In the long run, however, only policies to which the authorities are fully committed can be credible, and imposing restrictions on policy in the absence of such commitment can be disastrous. (12.4.3)	Yes.	
3. The pros and cons of fixed versus flexible exchange rate regimes need to be assessed carefully—there is no universal right answer. (12.4.3).	Yes.	Very general statement.
D. Policies to insulate the poor against shocks		
1. The resources allocated to social safety nets should be protected during adjustment, when fiscal tightening may be necessary. (12.4.4)	Yes.	
2. It is important that safety nets be operating before an economy is hit by a shock. However, if they are not, “second best” social protection policies may be necessary. (12.4.4)	Yes.	
3. Relaxing foreign currency controls in a well-managed fashion can give the poor access to safer assets, such as foreign currency, that can protect them from shocks that lead to devaluation. (12.4.4)	No (overly prescriptive—goes beyond the evidence).	No.
4. Severe financial repression, such as controlled interest rates, can impede the ability of the poor to save. Properly managed, financial liberalization policies can have the additional benefit of increasing self-insurance for the poor. (12.4.)	Partial (broader risks associated with a mishandled sequence of financial liberalization are not emphasized).	

¹The policy prescriptions described here are a summary of those contained in Chapter 12 (“Macroeconomic Issues”) of the PRSP Sourcebook. The policy recommendation assessed is the more complete description contained in the Sourcebook and not just the summary given here. Section references are to the Sourcebook chapter.

²The purpose is not to provide a judgment on the merits of the policy advice per se, but to assess whether it can be interpreted as signaling a reasonable degree of policy flexibility to guide a homegrown policy debate.

³In some cases, no entry is made on the “supporting evidence” because the policy prescription in the preceding column is very general and essentially calls for a case-by-case assessment.