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Policy Space: What, for What, and Where?

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This article examines how developing countries can use, and enlarge, existing policy space, without opting out of international commitments. It argues that: (i) a meaningful context for policy space must extend beyond trade policy and include macroeconomic and exchange-rate policies that will achieve developmental goals more effectively; (ii) policy space depends not only on international rules but also on the impact of international market conditions and policy decisions taken in other countries on the effectiveness of national policy instruments; and (iii) international integration affects policy space through several factors that pull in opposite directions; whether it increases or reduces policy space differs by country and type of integration.

Key words: Policy space, economic development, multilateral agreements, development strategies

1 Introduction

Much of the current debate on the role of national policies in economic development concerns the concept of 'policy space' and focuses on the tension between international economic integration and the autonomy available to nation states to pursue policies that effectively support their economic development. As noted by Cooper (1968: 5), this tension arises from the dilemma of 'how to keep the manifold benefits of extensive international economic intercourse free of crippling restrictions while at the same time preserving a maximum degree of freedom for each nation to pursue its legitimate economic objectives'.

Recent concern about the tension relates mainly to two factors. First, the policy agenda which many developing countries pursued during the 1980s and 1990s did not result in the desired acceleration of economic development (see, for example, World Bank, 2005). Second, the greatly increased internationalisation of markets and the associated stronger impact of foreign factors on national development have in many instances weakened the effectiveness of domestic policies. These factors combined triggered a debate on the commonalities of successful growth strategies that could frame the conduct of economic policies and the de

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development strategies (UN Millennium Project (Sachs Report), 2005; World Bank, 2005; United Nations, 2007; Commission on Growth and Development (Spence Report), 2008). This debate remains unsettled, but in general it emphasises 'that there is no universal set of rules' and 'that growth entails more than the efficient use of resources' (World Bank, 2005: xii and 10).

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arguments[3] against applying that theory as a blueprint, both policy-makers and economists who provide policy advice generally adopt, explicitly or implicitly, its basic ingredients. Those ingredients are: (i) a set of instruments that are subject to direct control by policy-makers, (ii) a set of targets that describe the evolution of the national economy and (iii) a model which describes the economic relationships between instruments and targets, as well as the choices available to policy-makers to attain desired values of the targets by applying specific instruments. Given that a multitude of instruments have an impact on the chosen targets and that often there are significant time-lags before such impacts become measurable, it is useful also to include a number of intermediate targets in the model in addition to a small number of ultimate target variables.[4] There are two important rules of the theory of economic policy: (i) the number of policy instruments must be at least as great as the number of targets if all targets are to be attained, and (ii) in case of trade-offs between target variables, policy-makers must use a social welfare function to decide which combination of instruments maximises the degree to which a consistent set of targets can be attained.

Policy-makers in closed economies have full sovereign command over policy instruments, but they may not be able to control specific policy targets effectively. First, potential trade-offs in the effectiveness of different instruments, as well as in the objectives sought, make it difficult to combine the available instruments in a way that would enable all targets to be attained simultaneously (van Velthoven, 1990). Second, instruments can be used only within specific boundaries (Bryant, 1980: 173). For example, there is a limit to how far nominal interest rates can be lowered. Third, the relationships between policy instruments and targets are often unstable, and knowledge and information about these relationships are usually incomplete. This problem is particularly acute in developing countries where policy aims at achieving structural change and thus involves a continuous adaptation of targets, instruments and behavioural relations rather than a routine use of a given instrument-target relationship. This need for constant adaptation makes it desirable to have available as many effective policy instruments as possible (Cooper, 1968: 153-4).

To analyse instrument-target relationships in an internationally integrated economy, it is useful to distinguish *de jure* sovereignty, which involves the formal authority of national policy-makers over policy instruments, and *de facto* control, which involves the ability of national policy-makers to effectively influence specific targets through the skilful use of policy instruments (Cooper, 1968: 4; Bryant, 1980: 149-50). On this basis, national policy space can be defined as the combination of *de jure* policy sovereignty and *de facto* national policy autonomy.

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incentives and on the behaviour of both policy-makers and individuals, and thus on the structural characteristics of instrument-target relationships.

3. Van Velthoven (1990) discusses four major criticisms: (i) rational expectations, suggesting policy ineffectiveness, (ii) the Lucas critique, suggesting that the coefficients of the model describing instrument-target relationships will in part reflect the specific combination of instruments applied during the period over which they are estimated, and thus need not be stable, (iii) information constraints and decision costs, which further reduce the certainty with which a given set of instruments can attain the targets that define a specific level of social welfare, and (iv) public choice issues which question whether public-sector decision-making is an adequate reflection of citizens' preferences.
4. For example, controlling investment-to-GDP ratios or technology and education levels can be intermediate targets for achieving income growth.

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This distinction suggests that international economic integration affects national policy space through several forces that pull in opposite directions. The process of integration into the global economy restricts national policy space both in terms of a reduction in the number of available instruments as a result of legal commitments to international rules and practices (i.e. constraints on *de jure* policy sovereignty), and in terms of the reduced effectiveness of macroeconomic instruments (i.e. constraints on *de facto* policy autonomy). At the same time, integration enlarges national policy space in terms of *de facto* control because (i) multilateral rules and disciplines enable a co-ordinated response to cross-border disturbances and prevent policy-makers in countries that can have a disproportionately large impact on the evolution of other economies from adopting discriminatory or beggar-thy-neighbour policies, thus restoring part of the effectiveness of domestic instrument-target relationships in internationally less influential countries; and because (ii) integration into a larger market increases the effectiveness of many structural policies, particularly those whose effectiveness strongly depends on scale economies or the disciplines of international competition.

The workings of these different forces, which make policy space an issue of finding the right balance, can be considered more precisely as follows:

(i) Integration into international economic relationships weakens *de facto* control over national economic development by allowing foreign actions and conditions to influence national macroeconomic policy targets.[5] This reduced effectiveness in the ability to control national policy targets is most prominent in monetary policy. As national money and capital markets are joined by international flows of funds, interest rates tend to converge across countries. This can create trade-offs between attaining internal or external targets. For example, in response to changes in international financial markets domestic policy-makers may be compelled to change the level of the domestic interest rate because the *relative* difference in interest rates affects cross-border capital movements. However, such a change may result in an *absolute* level of the interest rate that is inappropriate for attaining domestic policy targets. Moreover, with an open capital account both the exchange rate and the interest rate are potential policy instruments, but only one of them can actually be employed independently.[6]

(ii) Multilateral rules and disciplines, as well as commitments resulting from bilateral agreements, reduce *de jure* sovereign control over policy instruments. For example, the conditionality attached to assistance from the international financial institutions reduces the autonomy of governments to determine the size of public expenditures, and WTO agreements reduce the scope for Member States to impose

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over national policy targets by promoting economic integration. This weakening of sovereignty and of the effectiveness of national instruments over national targets must be weighed against the gains from integration into international markets and participation in the system of multilateral rules and disciplines.

(iii) While *de facto* integration into international markets reduces the effectiveness of national macroeconomic policies, it can improve the effectiveness of many structural policies that are of crucial importance for developing countries. Increasing returns to scale on an industry-wide basis and enhanced technological upgrading are the two main channels that, compared with policies in closed economies, make outward-oriented policies more effective in establishing competitive industries, thus improving the effectiveness of national sectoral and technology policies. For example, technological upgrading in developing countries often depends on the availability of foreign technologies embodied in imported capital goods, particularly during the initial stages of industrialisation. Economic integration facilitates access to foreign technologies, and the foreign exchange earned from exporting alleviates the balance-of-payments constraint. Both these mechanisms combine to reinforce the effectiveness of a country's sectoral and technology policies to build productive capacity and spur productivity growth.[7] Regarding financial integration, access to international financial markets enables domestic firms to finance investment under internationally competitive conditions, which increases the effectiveness of national investment policies.[8]

(iv) Multilateral rules and disciplines can also improve national policy effectiveness.[9] Globalisation provides an opportunity for policy-makers in influential
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agreements or staying out of any multilateral commitments altogether.[10] As far as systemic stability in international money and finance is concerned, it is likely that emerging economies will remain vulnerable to currency and financial crises as long as the currencies of the major industrial countries remain subject to large gyrations. By contrast, macroeconomic policy co-ordination and multilateral monetary and financial disciplines that would ensure stable and well-aligned exchange rates among the key currencies would shield weaker and smaller economies from adverse impulses originating from monetary and fiscal policies in the major countries.

For global collective action to be acceptable to all parties, it must result from a bargaining process based on the full, equal and voluntary participation of all the parties concerned. However, there is a natural inclination, particularly on the part of internationally powerful countries, to shape multilateral arrangements in a way that gives them maximum flexibility to pursue their own goals while restricting the degrees of freedom for others in areas of conflicting national interests. Countries that feel disadvantaged by the way multilateral rules and commitments are formulated and implemented can, in principle, choose not to participate in or leave the multilateral arrangements in question and conduct international relations on a bilateral basis. But countries with little power internationally (i.e. the vast majority of developing, as well as many developed, countries) will not be well-advised to follow this route, because coercive action is likely to be even stronger in bilateral relationships with major economic and political powers.

To sum up, the tension between international economic integration, on the one hand, and the degree of autonomy available to a country to implement policies that effectively influence its economic performance, on the other, is governed by both its *de facto* integration into international markets and its *de jure* integration into supranational governance structures. How to determine the right balance between maintaining flexibility in national economic policy-making and reducing it through multilateral disciplines and collective governance remains a contentious issue. On the one hand, the absence of multilateral disciplines can disrupt international economic relations and/or bias them in favour of those countries that wield substantial economic or political power. On the other hand, an increasing extension of legally binding external constraints on national economic policies, including multilateral rules and obligations established without the full participation of all countries concerned and biased against the interests of some groups of countries, would unduly impinge on the availability or effectiveness of national policy instruments.

However, there is no *quantifiable* single balance between multilateral disciplines and national policy autonomy that suits all countries or applies across all spheres of economic activity. As further discussed in Section 6, individual countries need to consider several factors when they evaluate the specific trade-offs of international integration they face.

10. Indeed, the fact that multilateral commitments also bind strong partner countries to abide by the rules may be valued by weak countries more than their gain in market access, which according to Polaski (2006) now is likely to be fairly small and concentrated in a handful of countries.

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between stabilisation and growth, as well as the potentially adverse impacts of international market forces – unleashed through broad-based trade and financial integration – on stabilisation and growth. Furthermore, it criticises this approach for considering its policy agenda as a blueprint, with insufficient attention given to country-specific conditions. In this sense, the heterodox perspective does not prescribe a different, but still globally applicablecond 27 (a27 -0.0017 Tc 0.3230 Tw 10902 5ticises2li5nfi

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3.1 Macroeconomic and [illegible] policies

The heterodox perspective considers macroeconomic stabilisation and growth policies to be closely interrelated. On the one hand, the monetary and fiscal policy mix influences the behaviour of real interest rates, exchange rates, output, wages and asset prices, which in turn strongly influences investment and savings decisions, as well as the international competitiveness of a country's enterprises. On the other hand, aggregate income growth fosters household savings and, through the automatic stabilisers, fiscal accounts, as well as productivity growth that enables non-inflationary wage growth. Hence, in order to be conducive to productive investment and income growth, macroeconomic stabilisation should be targeted at real, rather than monetary, variables (such as real output, real interest and real exchange rates) and should aim at encouraging and supporting the creation and expansion of internationally competitive productive capacity.

The heterodox perspective sees fiscal stabilisation as a key instrument for achieving overall macroeconomic stability, which in turn provides the foundation for price and exchange-rate stabilisation. It does not view low inflation itself as a policy target because, owing to uncertainty about the often only weak link between inflation and real variables, it is preferable to focus directly on observable real variables. Moreover, moderate inflation rates are considered unlikely to impede economic growth. According to a wide range of studies, inflation is detrimental to growth only if it is in excess of a certain threshold. While there is no agreement on the level of that threshold, it is often considered to be around 10% per annum.[12] In addition to the stabilisation effects stemming from the monetary and fiscal policy mix, the heterodox perspective recommends achieving price stability through an incomes policy (i.e. controlling wage growth as a source of cost inflation by coercing or persuading employers and employees to restrict their price and wage increases within a given level of overall productivity growth).

With incomes and fiscal policies being the main instruments to control inflation, monetary policy can be targeted at economic growth. The following are its immediate targets from a heterodox perspective: maintaining interest rates at levels that provide domestic credit on terms and conditions offering appropriate incentives for productive investment; maintaining a competitive and stable real exchange rate; and ensuring the development and stability of the domestic financial system. At the same time, balance-sheet vulnerabilities (for example, caused by liability dollarisation and maturity mismatches) must be minimised to foster financial-sector stability. Financial development, supported by banking and non-bank financial regulations, safeguards most domestic control over policy variables if it creates and consolidates domestic-

12. Khan and Senhadji (2001) indicate a threshold of 11-12% per annum for developing countries; they also discuss the findings of earlier studies which mostly found higher threshold levels. The rationale for allowing moderate inflation rates is also based on the strongly adverse economic impact of deflation and the fact that monetary policy is ineffective when an economy is in deflation. Moreover, there are important trade-offs between rapid disinflation and growth, because with rapidly falling inflation high nominal interest rates quickly translate into high real interest rates that discourage productive investment and limit growth.

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currency-denominated intermediation instruments (for example, bank loans, corporate bonds, securitised assets) that facilitate productive investment.

The heterodox perspective argues that the volatility and pro-cyclical character of short-term capital flows requires the prudential management of such flows in order to preserve macroeconomic stability and allow policy-makers to use restrictive monetary policy during economic upswings and avoid excessively contractionary policies during slowdowns. The key objective of such management is preventing the cumulative build-up of foreign liabilities that can be easily reversed; in other words, preventing cyclical upturns in external financing from triggering excessive increases in external credit to the domestic private sector, preventing capital inflows from causing real exchange-rate

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economic development. However, due to the multitude of information and co-ordination failures associated with investment and productivity growth, relying on the incentives generated from allocative efficiency may not suffice (Rodrik, 2004). Rather, the heterodox perspective emphasises the need for proactive trade and industrial policies to foster nascent industrial activity and promote technology transfer and adaptation. The range of instruments designed to attain such targets include performance requirements for foreign investors, subsidies conditional on export performance to encourage the international competitiveness of nascent domestic manufacturing, flexible use of compulsory licensing for the domestic use of protected foreign intellectual property, a flexible import-tariff policy that modulates applied tariffs on particular manufacturing sectors around a stable average level, and many more.

Rodrik (2004) argues that the aim of proactive trade and industrial policies is not to pick winners, but to identify and discipline underperforming firms. Thus, the establishment of clear operational goals, time horizons and sunset clauses, as well as the adoption and effective monitoring of observable performance criteria, are critical to the success of this strategy. In a sense, the enforcement of performance requirements, particularly those related to productivity gains as imposed by the disciplines of the international market, represents the 'stick' that complements the 'carrot' provided by the creation of rents from productivity-enhancing investment supported by temporary subsidies and protection. It is by constraining the use of such trade-related performance requirements that, from a heterodox perspective, the UR agreements most seriously reduce developing countries' policy space.

3.3 Institutions

Regarding institutional arrangements, the heterodox perspective emphasises that government action is a strategic complement to markets. Juxtaposing government and markets, or government failures and market failures, would be misleading. Rather, Regfoti both

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	Sources of current restrictions on national policy space	Measures for preserving or enlarging existing policy space without opting out of existing commitments	
		National measures	International measures
Structural policies: mainly trade & industrial policies	*De jure* trade integration through both multilateral &, in particular, bilateral & regional North-South agreements [Reduces number of available policy instuments]	Reassessment of policy targets & instrument-target relationships, from emphasising maximisation of export market access & FDI inflows towards maximising creation of domestic value added & linkages [Strategic integration makes contribution of trade & industrial policies to real output growth & structural change more effective] Avoidance of additional constraints from bilateral trade & investment	

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agricultural policy space than to maintaining their own policy space for industrial tariffs. Meanwhile, North-South economic integration agreements have resulted in further *de jure* constraints, as discussed in the preceding section.

It is through supposedly sovereign decisions that developing-country policy-makers sign on to the commitments of international trade agreements that reduce *de jure* policy space. This may partly reflect some preference for short-term benefits over autonomy in deciding on their long-term policy options.[18] But different degrees of influence between developed and developing countries on globalisation trends and global economic governance often confront policy-makers with difficult trade-offs. Regarding the commitments stemming from the UR agreements, Finger and Nogues (2002) note that, at the end of the negotiations, developing countries were faced with the choice of accepting what was proposed or risking being marginalised in the international trade regime.[19] As for engagement in North-South integration agreements, Baldwin (1997) notes a domino effect: existing North-South preferential agreements tempt non-members to join so as not to lose out on access to sizeable export markets and sources of FDI. Hence, while engaging in international commitments may be a 'sovereign' decision, there is often little alternative.

Preserving the remaining multilateral *de jure* policy space for developing countries to undertake structural policies implies that, at the international level, moves to multilateralise bilateral and regional trade agreements should not extend to their WTO-plus commitments. It also implies that a potential further tightening of WTO rules should emphasise greater discipline on developed countries' use of trade contingency measures (for example, the practice of zeroing in anti-dumping) and of agricultural support and protection. At the national level, it would imply a reassessment of the relative benefits stemming from greater export-market access and FDI inflows, on the one hand, and flexibilities in policies designed to maximise the creation of domestic linkages and value added, on the other.

In spite of exposing the domestic economy to a number of adverse influences originating in international markets, *de facto* international integration preserves significant national policy space. As outlined in the previous section, fully exploiting this space requires a reassessment of policy targets and instrument-target relationships at the national level. Such a reassessment, including the use of a greater number of policy instruments, would aim at pursuing more proactive macroeconomic and structural policies, while reducing the vulnerability of the domestic economy to the adverse spillover effects of international monetary and financial disturbances.

The developmental effectiveness of macroeconomic and structural policies would be strengthened by a reorientation of developing countries' institutional arrangements

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upheaval created severe liquidity problems for many firms that had high foreign-currency-denominated debt. The Korean currency depreciated sharply and firms indebted in foreign currency faced bankruptcy, as the dismantling of industrial policy had also abolished the policy instrument of the government acting as a lender of last resort.

It is widely acknowledged that the accumulation of sizeable foreign-exchange

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market and previous integration into international goods markets are significant factors in determining the impact of integrating a country's capital market on the effectiveness of its monetary and financial policies.

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