

**African Fiscal Forum: Fiscal Policy Challenges in Africa
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A Policymaker's Perspective on Key Fiscal challenges

1. Introduction

I would like to begin by thanking the South African National Treasury and the IMF for according me the honour of presenting a keynote speech at the African Fiscal Forum. The policymakers' perspective that I bring to the forum is primarily that of a central banker and hence my views of fiscal policy focus on its interaction with monetary policy as a tool of short to medium term demand management, to stabilise the economy in the face of macroeconomic shocks. I will address this issue in the first part of my speech. But I also want to address, in the second part of my speech, what I believe should be the priority developmental objective on the continent; the creation of more formal jobs in the private sector. Tackling this challenge requires structural policies which are largely in the domain of fiscal policy, rather than monetary policy. I also believe that the reforms of fiscal policies have implications for Fund programs and so I will highlight some of the areas where I think that changes in these programs are desirable.

2. Stabilisation policies

The macroeconomic environment facing policymakers in Sub-Saharan Africa (SSA) has become much more difficult since the global economic crisis erupted in 2008. Our economies have been buffeted by multiple shocks; for example, to food and fuel prices, to export markets and, for the frontier markets in SSA, to portfolio capital flows. The

problems facing the global economy, including the need for a global rebalancing of demand, the volatility of commodity prices and vulnerabilities in financial markets, imply that SSA cannot expect any abatement of external shocks to its economies over the medium term at least, if not over a longer time horizon.

The macroeconomic reforms which have been implemented in many African countries have already helped to make their economies more resilient in the face of external shocks. Nevertheless, I believe that we can draw lessons from our experience of dealing with the macroeconomic shocks that have recently hit our economies to guide further strengthening of macroeconomic policies.

Monetary policy should be the macroeconomic management tool of first resort; it can be implemented much more flexibly and quickly than fiscal policy. So I hope you will bear with me while I make a brief detour to discuss monetary policy.

Monetary policy frameworks need to be modernised and strengthened, especially in the frontier markets in SSA. The quantitative monetary targeting frameworks that remain the norm in SSA, outside of the common currency zones, do not provide an effective framework for macroeconomic stabilisation policies. They are too rigid, the velocity of circulation of money is too unpredictable, breaking the link between monetary growth and inflation, and they are not transparent. Because of these deficiencies, the Bank of Uganda replaced monetary targets with an inflation targeting lite framework in July, the centrepiece of which is a policy interest rate, which we call the Central Bank Rate and which is set at the start of every month and announced to the public. In the debate about the optimal monetary policy framework, much of the interest has focussed on the transmission mechanism of monetary policy and the relative efficacy of quantities and prices in financial markets in influencing aggregate demand. What has been neglected in the debate is the value of a publicly announced policy rate as a signal of the stance of monetary policy. Our introduction of the Central Bank Rate in Uganda at the start of July has hugely enhanced the understanding of our monetary policy actions and our objectives among the public and market participants, which will strengthen the effectiveness of monetary policy and help us to shape expectations about the course of inflation among the public.

The IMF has been somewhat ambivalent about reforming monetary policy frameworks in SSA, reluctant to abandon quantitative monetary targets even though it has supported the introduction of inflation targeting frameworks elsewhere in the world and its Research Department has published some excellent working papers on the issue.ⁱ I hope that the Fund will take a more positive view of the merits of introducing inflation targeting frameworks in SSA. In practical terms, the Fund can assist central banks to introduce inflation targeting monetary policy frameworks by providing technical assistance, drawing on the expertise it has acquired in other parts of the world, and by replacing the quantitative monetary targets in Fund programs with targets which are more relevant to inflation targeting monetary policy frameworks.

The modernisation of monetary policy frameworks in SSA has implications for fiscal policy and, in particular, the domestic financing of the budget. If central banks are to have the freedom to set monetary policy to achieve an inflation target, they should not be expected to finance the government's domestic borrowing requirement, except perhaps by providing small overdrafts on a purely temporary basis to bridge cash flow shortfalls. Governments should meet all of their domestic financing needs from the market, by issuing securities on a competitive basis. Furthermore, there should be a clear separation of the instruments used for monetary policy and budget financing. My preference is that primary securities auctions should be used solely to fund the government domestic borrowing requirement while monetary policy operations should be carried out using secondary market instruments, although I realise that the specific circumstances prevailing in other countries might dictate alternative arrangements. We also need to step up efforts to deepen domestic debt markets and enhance their liquidity. This will have the double benefit of increasing the scope for government to mobilise finance domestically and strengthening the transmission mechanism of monetary policy.

Finally, we should not ignore the important contribution which fiscal policy can make to macroeconomic stabilisation. I argued above that monetary policy should be the preferred tool of stabilisation policy because it is flexible and can be implemented quickly, but there are limits to the effectiveness of monetary policy in economies with small and poorly integrated financial sectors. Hence in some circumstances it will be

necessary to supplement monetary policy with fiscal policy. For example, in the aftermath of the global financial crisis, many governments felt it necessary to use both monetary and fiscal measures to stimulate their economies.ⁱⁱ

African countries have created the fiscal space for countercyclical fiscal policy by improving their public finances, in particular by lowering public debt. However, the ability to actually implement a countercyclical fiscal policy in a timely manner is still constrained both by the nature of expenditures in government budgets and by administrative capacity weaknesses. Efforts to ramp up capital spending to stimulate demand often fail because the technical and administrative capacities required to plan and implement projects expeditiously are lacking. If countercyclical fiscal policy is to be a feasible policy option in SSA, it will be necessary to identify areas of public spending which can be varied over the course of the economic cycle in a manner which does not detract from the efficiency of the spending. Furthermore, it must be possible to wind down such expenditures quickly once the need for a fiscal stimulus has abated, so that higher spending on these items does not become a permanent feature of the budget.

3. Implications for the fiscal targets in Fund programs

I would like to turn now to the design of Fund programs and suggest changes to the quantitative fiscal targets which could support the strengthening of fiscal policy in SSA.

Fund programs in SSA tend to take a narrow view of the appropriate fiscal stance, by setting a target for government net domestic borrowing as a quantitative performance criterion. A target of this nature is becoming outdated for the frontier markets of SSA, for three reasons. First, with the deepening of domestic financial markets, and the possibility of attracting external portfolio investment into the domestic securities markets, rigid ceilings on government domestic borrowing are no longer as critical for macroeconomic stability as they were in the past. Second, the domestic borrowing target imparts a pro-cyclical bias to fiscal policy; when budget revenues fall because of lower than forecast economic activity, public spending must be cut to meet the target. As such it is an impediment to the more flexible use of fiscal policy as a countercyclical stabilization tool. Third, a domestic borrowing target provides only a partial indicator of

the stance of fiscal policy - its impact on aggregate demand - which is what matters for macroeconomic management. A more comprehensive indicator would be an appropriate measure of the fiscal deficit, preferably a structural measure of the deficit to avoid a pro-cyclical bias.

Fund programs in SSA also impose strict limits on non concessional external public borrowing. There is a rationale for such limits for countries facing external debt problems, and which require debt relief to restore debt sustainability. But debt sustainability is no longer a binding constraint for many countries in SSA, where debt burdens have been reduced substantially through improved fiscal balances and debt relief. African countries can derive important benefits from accessing international commercial debt markets, through issuing sovereign bonds as some countries already have. Sources of public finance are diversified; dependence on donor aid is reduced; and sovereign borrowing costs can provide a benchmark for the private sector to access foreign capital. Furthermore, in order to access commercial bond markets, Governments need to obtain and maintain a good sovereign credit rating from the rating agencies, which provides a powerful incentive to policymakers to pursue sound macroeconomic policies. The public debt related targets in Fund programs should be flexible enough to allow African countries to access commercial debt markets in a prudent manner.

4. Long term developmental priorities

I now want to turn away from the challenges of short term macroeconomic stabilisation and focus on long term developmental priorities.

As has been reported and analysed in many of the recent editions of the Regional Economic Outlook for SSA, the growth performance of the region has improved markedly over the last decade. Real GDP growth has averaged almost 6 percent since 2004, which is about double the average growth rate in the 1990s. The higher growth rates have also been accompanied by sectoral shifts in the structure of output, with the share of agriculture in GDP falling and that of services rising. However, in key respects, the character of economic growth in SSA has been disappointing. In particular the

creation of formal sector employment falls far short of what is required to generate structural transformation and to meet the aspirations of jobseekers and thus avoid social discontent. The main shifts in labour markets have entailed workers moving from informal employment in agriculture into the informal services sector. The share of the workforce in manufacturing has actually fallen.

The latest edition of the Regional Economic Outlook for SSA provided some data on the composition of employment in six countries. On average in these countries, only 13.6 percent of the working age population has a formal sector job with a salary or wage, a statistic which compares very unfavourably with developing Asia. A World Bank report, entitled “Working Out of Poverty”ⁱⁱⁱ, reached similar conclusions, reporting that 80 percent of the labour force in Africa is self-employed. Formal sector employment may be growing slightly faster than the workforce, but given the very low base of formal employment, the difference is not large enough to bring about a significant shift of the workforce into formal sector employment.

Does the lack of formal sector job creation matter? I believe that it is of profound importance. It is symptomatic of the failure to develop modern labour intensive industries on a large scale in SSA. Such industries provide the engine of structural economic transformation because they can utilise modern technology and because they have incentives to continuously improve efficiency by upgrading their technology. The small scale informal enterprises which absorb most of the workforce in SSA lack the resources or know how to do this; their technology and productivity is essentially stagnant.

The key to formal sector job creation is much higher levels of private investment in labour intensive industries. Private investment in SSA is not more than half the level in developing Asia.^{iv} Furthermore, private investment in SSA is concentrated in capital intensive industry and housing, which creates few jobs. The “Working Out of Poverty” report by the World Bank concluded that “Investment in large-scale, labour intensive manufacturing firms, the locus of the majority of private sector wage and salary jobs in the past, has been very weak in Africa despite good overall economic performance”.^v The report also argued that the main impediment to private investment is the poor

business environment in Africa; transactions costs and risks are high and institutional and human capacities are weak.

Boosting private investment in labour intensive industry should be the priority developmental objective; it is a prerequisite for both the structural transformation of the economy and the formal sector job creation. It is a challenge which fiscal policy is best suited to address, because many of the policy requirements are structural in nature and involve either the revenue or expenditure sides of the budget. I would like to highlight two aspects of fiscal policy which are relevant for the business environment for private sector investment in SSA, although I recognise that many other aspects are also important.

The first pertains to the often contentious issue of fiscal incentives for private investors. As is well known, some of the successful newly industrialised economies in Asia employed what are usually termed industrial policies – fiscal incentives, cheap credit, selective protection, etc – to promote investment in manufacturing industries. Many governments in SSA have adopted a somewhat half-hearted version of the Asian strategy. Without having anything which might accurately be described as a coherent set of industrial policies, they have nevertheless offered various fiscal incentives – tax holidays, duty exemptions, etc – to selected private investors. It is rather worrying that there appears to be very little rigorous evaluation of the impact of these fiscal incentives in SSA, either in terms of whether they have made any positive contribution to attracting private investment or in respect to the revenue that has been lost.^{vi} They have been offered rather more in hope than expectation that they will yield any positive results. There is undoubtedly strong pressure from politicians and the business sector for fiscal concessions; pressure which is harder to resist because technocrats have not been able to offer any convincing alternative policies which could promise better results.

I think that there are grounds to offer incentives to private sector investors in priority sectors, but not before we have a clear understanding of how to design incentives which will actually work and will also minimise the revenue losses. I don't have much to contribute about the design of such incentives, other than that I think that the cost-benefit calculus will be improved the more transparent that they are and the less scope

that they offer for discretionary action on the part of public officials charged with their implementation. Incentives should also be directly linked in some way to the performance of firms, so that they do not become a tool for propping up firms which are barely viable and offer no prospect of dynamic growth. A coordinated regional approach to incentives policy is imperative, to avoid beggar thy neighbour competition.

I hope that the Fund, which has a wealth of expertise on issues of tax policy, could assist African governments to design cost effective fiscal incentives for private investment, or to design other types of non fiscal incentives. More empirical research on this issue is warranted and this should include an appraisal of whether (and why) industrial policies were effective in developing Asia and how applicable they might be to other developing economies.

Finally, we should be cognisant of the potential long term impact of fiscal policy decisions on the real exchange rate and thus on incentives for private investment in different sectors of the economy. The stance of fiscal policy affects the real exchange rate because of its impact on demand for non traded goods. Government expenditures largely comprise non traded goods. Hence in general, a more expansionary stance, *ceteris paribus*, will tend to appreciate the real exchange rate because it raises demand for non traded goods, thereby pushing up their prices relative to those of traded goods. This is particularly pertinent for economies which rely heavily on donor aid or the revenues from the export of natural resources for budgetary resources. A more appreciated real exchange rate shifts incentives for private investment away from the traded goods sectors. It is potentially damaging for long term growth and employment creation because traded goods industries often provide a much more dynamic engine of growth than non traded goods industries, as the former are subject to more competitive output markets which force firms to continuously improve their efficiency.

The successful economies of developing Asia have sustained very high rates of investment but have even higher savings rates, which helps to explain why their traded goods sectors have been so competitive. Structural transformation in SSA requires much higher rates of investment but it also needs higher domestic savings mobilisation, for which a stronger public savings effort could make an important contribution.

5. Conclusion

Policymakers in SSA face a raft of difficult challenges, many of which have their solutions in fiscal policy reforms. I have tried to highlight some of these challenges which I think are important across a range of countries in SSA. There are clearly many others which I have not mentioned. Looking ahead I think it is fair to conclude that SSA will enjoy more opportunities to promote its developmental goals, taking advantage for example of a diversification of financing sources for government budgets and the potential to exploit new markets in the fast growing developing economies. But we will also face a more risky economic environment. As a consequence, the premium on good economic policies, whether fiscal or monetary, will be raised. Our decisions as policymakers will have profound consequences.

Thank you for listening.

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ⁱ See for example, Freedman and Otker-Robe, 2010.

ⁱⁱ Kasekende, Brixova and Ndikumana (2010).

ⁱⁱⁱ Fox and Gaal (2010).

^{iv} African Development Bank (2008; p56) provides data which indicates that the average level of private investment to GDP in Africa was 15.3 percent during 2000-06 and 17.2 percent in 2007. Total investment (public plus private) in developing Asia is about 40 percent of GDP; hence private investment in developing Asia is likely to be upwards of 30 percent of GDP.

^v Fox and Gaal, 2010: p10

^{vi} A survey in 2002 found that there is little evidence, from either econometric studies or investor surveys, that fiscal incentives are effective at attracting investment in a cost effective manner (Zee, Stotsky and Ley, 2002).