


Macroeconomic Alternatives & Financing of Public Services


James Heintz
(PERI, University of Massachusetts)
Cambridge, MA
March 13th, 2009



What I hope to talk about:

- ◆ Logic of IMF policy and critique of the approach.
 - Focus: increasing public resources for service delivery (e.g. health care)
 - ◆ Alternative approaches to macroeconomic management.
 - Alternative framework
 - Real world issues/constraints
 - ◆ What would an alternative approach mean?
- 

Logic of the IMF Approach: policy targets and instruments

- ◆ Examples of policy targets: economic growth, inflation, public finance, and budget allocations.
 - ◆ Examples of policy instruments: monetary policy, fiscal policy (budgets), exchange rates.
 - ◆ Challenge: policy targets are not perfectly compatible, trade-offs and constraints exist.
 - ◆ Therefore, one policy instrument often cannot manage more than one target or goal.
 - ◆ General rule: # of policy instruments should equal # of policy targets.
- 


How the IMF assigns policy instruments to policy targets

- ◆ Focus on sub-Saharan Africa.
- ◆ Target: price stability/low inflation.
 - Instrument: MONETARY POLICY
- ◆ Target: lower interest rates to encourage growth.
 - Instrument: FISCAL POLICY
 - Reduced government borrowing/budget constraints
- ◆ Social spending is subordinated to these other macroeconomic targets


Conduct of IMF-style monetary policy in African countries

- ◆ Monetary policy targets the growth rate of the money supply.
 - Central banks have influence over a small portion of the money supply
 - Currency and reserves of the banking system
- ◆ Logic: central banks attempt to manage the money supply → slower growth of the money supply will reduce inflation.

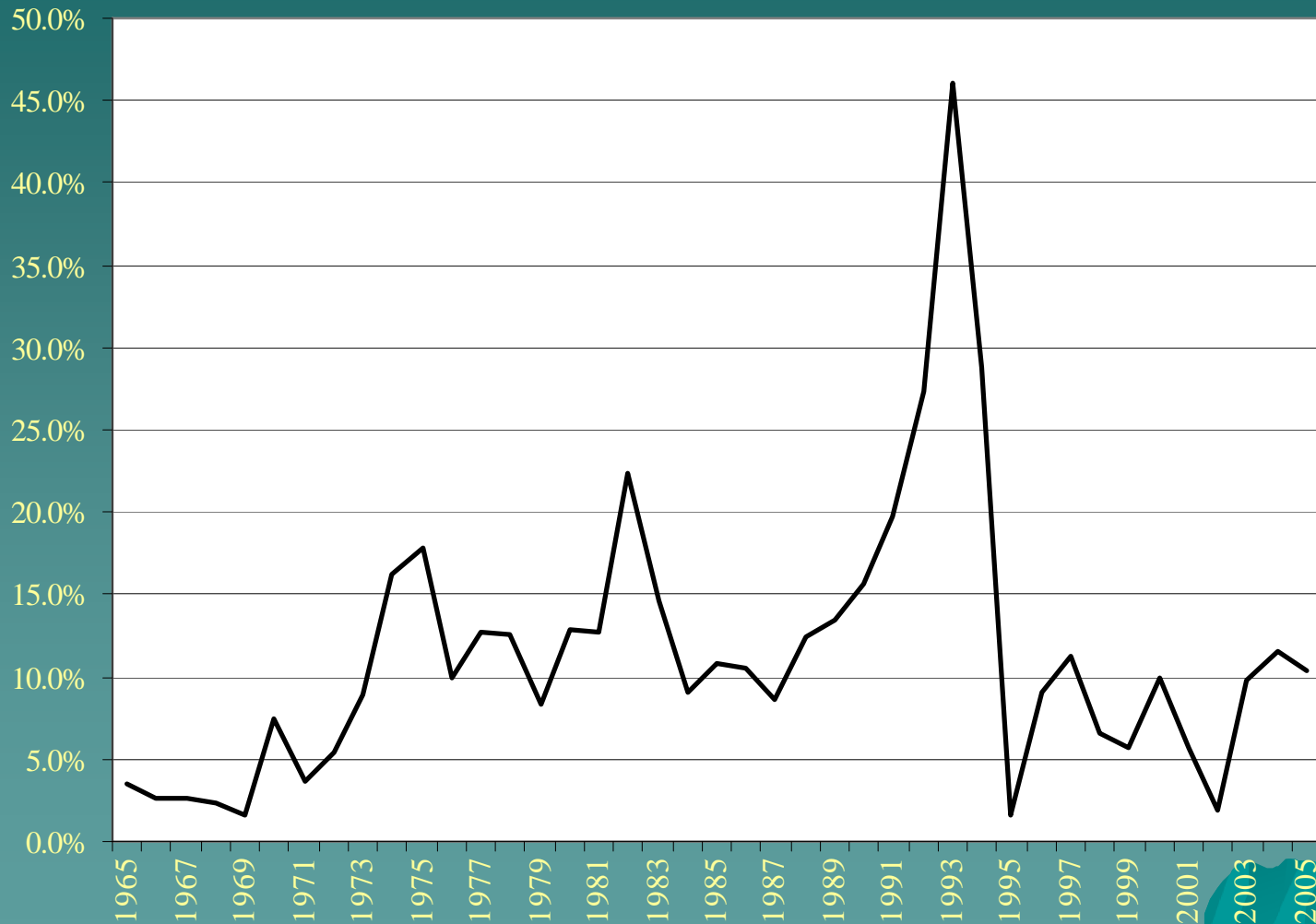
What's wrong with this approach to monetary policy?

- ◆ The policy instrument is not always effective. Central banks may have limited influence over the money supply (broadly defined).
 - ◆ The link between the money supply and inflation is often weak.
 - ◆ Uncontrollable growth of the money supply will lead to hyper-inflation, but monetary policy often cannot “fine tune” low rates of inflation.
 - ◆ Richer countries target interest rates, not the money supply (think about the U.S. Federal Reserve). Also – employment.
- 

Inflation targets: a critique

- ◆ Inflationary pressures in most low-income countries tend to come from price shocks (food, energy, etc.)
 - ◆ Monetary policy is not effective in managing this type of inflation (non-monetary shocks).
 - ◆ Tight monetary policy in response to a negative price shock can make the situation worse.
 - ◆ Many African countries have a history of fairly stable inflation.
 - ◆ IMF reforms can actually contribute to inflation (e.g. devaluing the currency)
- 

Example: Inflation in Kenya

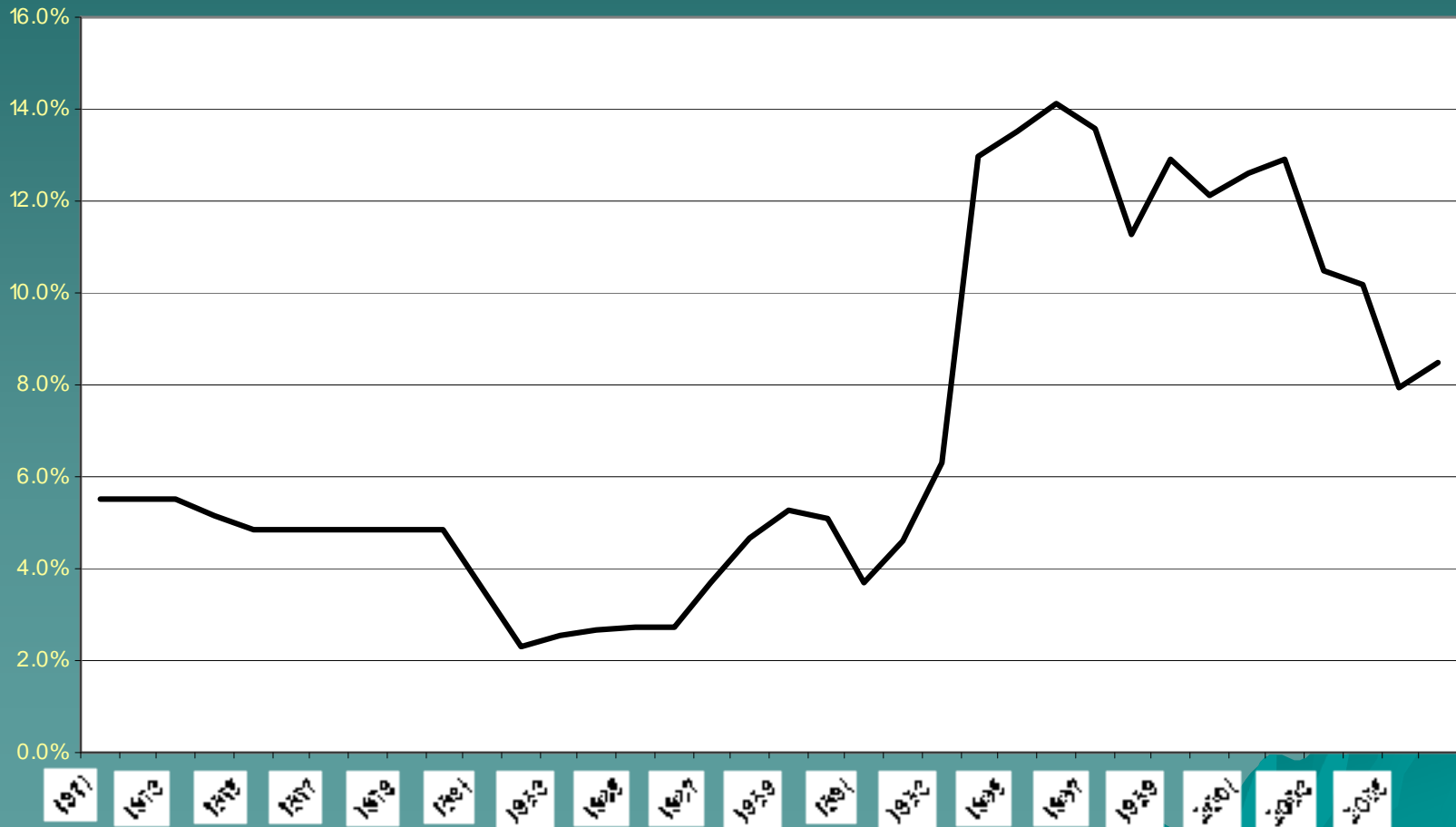


The role of fiscal policy

- ◆ Since monetary policy focuses on inflation control, the IMF framework often “assigns” fiscal policy to address interest rates.
- ◆ Argument: government borrowing and spending raises interest rates.
- ◆ Problem: many other factors have a stronger impact on domestic interest rates (e.g. monetary policy, international financial flows).
- ◆ IMF reforms (e.g. deregulation of the financial sector) often contribute to high borrowing rates.

Interest rate spreads in Kenya

Sprend: lending minus deposit rates, 1971-2006



An alternative framework

- ◆ Policy target: low interest rates to support growth.
 - Instrument: MONETARY POLICY TARGETING OF INFLATION-ADJUSTED INTEREST RATES.
- ◆ Policy target: developmental spending in the budget.
 - Instrument: FISCAL POLICY


What about inflation?

- ◆ Real interest rates = actual interest rates minus the rate of inflation.
- ◆ Monetary policy can target real interest rates at a low, positive level.
- ◆ Other policy instruments can also be used to help relieve inflationary pressures.
 - Example: infrastructure investments in transportation, storage facilities, and irrigation can reduce inflationary pressures due to fuel and food prices.

Other related policy issues

- ◆ International financial flows
 - May require regulations to prevent large financial outflows.
 - Represents a constraint on the operation of monetary policy.
- ◆ Exchange rates
 - IMF policy supports market-determined exchange rates.
 - However, exchange rate management can be used as an additional policy instrument. May require capital controls.
 - Inflation is often sensitive to exchange rate movements.
- ◆ Key point: expand the number of policy instruments to meet multiple targets

Developmental fiscal policy

- ◆ Increased development spending requires additional resources
 - ◆ Where will the money come from?
 - Mobilization of domestic tax revenues
 - Domestic borrowing: possibilities and constraints
 - Development assistance (aka Aid): macroeconomic issues
- 

Mobilizing domestic revenues

- ◆ There is growing evidence that simply improving revenue collection in African countries can significantly increase public resources available.
- ◆ Some lessons:
 - The constraint is often an institutional one
 - Partially independent tax collection authorities are often more efficient
 - Taxes (royalties/fees) on natural resource extraction critical for some countries
 - Trade agreements should take into account impact on revenues

Domestic Borrowing

- ◆ Often the focus is on external borrowing and debt relief. Domestic borrowing is also important.
- ◆ The costs of servicing the domestic debt (i.e. interest payments and related costs) can be very high.
 - A very real constraint on fiscal policy
 - More domestic borrowing may eventually “crowd out” development spending.

Why is domestic borrowing so costly?

- ◆ Who holds government bonds?
 - Domestic banking sector. Highly concentrated. Able to keep interest rates high.
- ◆ Short-term debt
 - Constant turn-over is expensive
- ◆ Uncoordinated macroeconomic policy
 - Tight monetary policy and slow growth makes domestic borrowing unsustainable.

Improving the environment for fiscal management

- ◆ Support government efforts to launch long-term bonds and restructure the debt.
- ◆ Real financial reform:
 - Policies to get banks to play a developmental role.
 - Carrots and sticks
- ◆ Coordinated approach to developmental macroeconomics

IMF Critique of development assistance

- ◆ The IMF has warned that “scaling up” development assistance may threaten macroeconomic stability.
 - e.g. the global fund for AIDS.
- ◆ Why?
 - The transfer of funds may destabilize monetary policy leading to inflation and exchange rate problems.

Logic of the IMF argument

- ◆ Transfer of funds: held in the central bank as foreign exchange reserves (e.g. dollars).
- ◆ As governments spend the money domestically, the funds enter the domestic banking system.
- ◆ Consequences: lose control of the money supply, generating inflation.

Problems with the IMF logic

- ◆ Earlier critique of monetary policy applies here, too.
- ◆ Assumes that spending will not have a significant impact on the productive capacity of the economy (i.e. "the supply side").
- ◆ Institutional issues:
 - Capacity of government ministries/ agencies to deliver is a valid concern. Need to build capacity. Donors can undermine capacity.
 - In the past – risk of capital flight. Foreign currency facilitated financial outflows
- ◆ Politics of development assistance and policy autonomy.

Macroeconomic alternatives: summing up

- ◆ New roles for monetary and fiscal policy
 - Monetary policy: targets low real interest rates
 - Fiscal policy: sustainable developmental spending
- ◆ Coordinated approach to macroeconomic management is essential.
- ◆ Expanding the number of policy instruments:
 - Public investment
 - Financial regulations
 - Exchange rate policies

Alternatives, cont.

- ◆ Towards developmental budgets
 - Improved revenue collection
 - Sustainable domestic borrowing
 - Wise use of development assistance
- ◆ Institutional issues are critical
 - Non-monetary sources of inflation
 - Real reform of the financial sector
 - Efficient, fair revenue collection
 - Delivery and accountability

How much does it matter?

- ◆ Example. Five modest assumptions.
 - 10 percent increase in domestic tax revenues due to better resource mobilization
 - 1.0 percent of GDP due to a combination of domestic borrowing and lower debt servicing costs (thanks to debt restructuring)
 - 10 percent increase in development assistance
 - One-third of the additional financial resources are targeted at health care expenditures
 - Revised macroeconomic framework that allows for greater public spending.

10 African countries

Country	Public Health Spending	Increased Public Finance by Source				Increase in public health expenditures
		Domestic Revenues	Domestic Borrowing / Debt Service	Official Development Assistance	Total	
	<i>Percent of GDP</i>					<i>% change</i>
Burkina Faso	3.3%	1.3%	1.0%	1.3%	3.6%	36%
Congo (DR)	1.1%	0.6%	1.0%	2.8%	4.4%	133%
Côte d'Ivoire	0.9%	1.5%	1.0%	0.1%	2.6%	96%
Ethiopia	2.7%	1.1%	1.0%	1.9%	4.0%	49%
Ghana	2.8%	2.2%	1.0%	1.5%	4.7%	56%
Kenya	1.8%	1.7%	1.0%	0.4%	3.1%	57%
Namibia	4.7%	2.6%	1.0%	0.3%	3.9%	28%
Sierra Leone	1.9%	1.1%	1.0%	3.4%	5.5%	96%
Swaziland	4.0%	2.6%	1.0%	0.1%	3.7%	31%
Uganda	2.5%	1.2%	1.0%	1.8%	4.0%	53%

Conclusions

- ◆ Relatively modest relaxation of current macroeconomic targets can yield significant changes in health spending.
 - ◆ Example is instructive, but basic health care needs would still not be met in most countries in the short-run.
 - ◆ Requires additional resource mobilization or budget re-prioritization.
 - ◆ Note: consequences could be far-reaching in the long-run.
- 