Louis Kasekende: The evolving nature of macroeconomic management in Sub-Saharan Africa and its implications for IMF programs

Speech by Dr Louis Kasekende, Deputy Governor of the Bank of Uganda, at a retreat with the IMF Resident Representative, Kampala, 26 January 2011.

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Introduction

Macroeconomic management is changing in Sub-Saharan Africa (SSA), especially in the so called "frontier markets". It is becoming more sophisticated as a result of improvements in technical capacities (in central banks and finance ministries) and because of the need to tackle more complex macroeconomic challenges, including those arising from global financial integration. One implication of these changes is that policymakers in SSA will, in future, place more emphasis on demand management within a business cycle framework than has hitherto been the case. The shifts in the nature and focus of macroeconomic management have been given impetus by Africa's experience of managing the impact of the global economic crisis, which on balance was quite successful; although there was a slowdown in economic growth in SSA in 2008 and 2009, most economies in the region avoided recession.[1] I want to highlight some of these changes to macroeconomic management and discuss what this might mean for IMF programs in SSA. These remarks are intended to provoke discussion about what I think are important issues for SSA and the IMF, and which will have to be addressed sooner or later.

IMF programs in SSA

IMF programs were originally designed for a specific purpose – to help economies adjust to temporary balance of payments (BOP) deficits. Hence they combined emergency liquidity support with quantitative targets for monetary and fiscal aggregates designed to constrain aggregate demand and protect the BOP (and hence the recipient's capacity to repay the IMF).

This is not the role of IMF programs in many countries of SSA today. Instead, SSA countries have implemented IMF programs on a long term basis – through a succession of consecutive IMF programs; even when these economies are not facing BOP crises and often when they don't even borrow from the IMF (or only borrow token amounts).[2]

The design of Fund programs in SSA – whether ESAF, PRGF, PSI etc – in terms of their macroeconomic conditionalities (the quantitative performance criteria) – is fundamentally the same whether viewed in a cross sectional perspective (across different countries in SSA) or through time (e.g. over the last 25 years). This is despite their being substantial heterogeneity among SSA economies and the significant changes that have occurred within the same economies over the last 25 years.

This begs three questions which I want to address.

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[1] See Brixova and Ndikumana (2010) and IMF (2010).

[2] IMF (2008) sets out the rationale for the IMF's engagement in Low Income Countries (LICs). The IMF perceives its role as extending far beyond support for the BOP. Instead this document states (page 3): "Fund engagement with LICs over the past decade has been focused on supporting macroeconomic stability – its key global mandate – as part of broader development efforts to reduce poverty, raise growth and secure progress towards the Millennium Development Goals (MDGs)".

1. Is the technical design of the macroeconomic conditionalities in Fund programs still appropriate for the macroeconomic challenges faced by all SSA economies, and in particular for the more advanced economies in the region; the "frontier markets"?
2. Should the IMF be more open minded about heterodox policy measures which are being implemented by many emerging market economies in Latin America and Asia, and which are attracting interest among African policymakers?
3. Is there still any value for SSA economies, which don't face temporary BOP problems and don't need to borrow from the IMF, in implementing IMF programs? Might these programs have actually become counterproductive?

The technical design of IMF programs in SSA

I want to focus here on the design of the macroeconomic conditionalities of IMF programs, which are fairly homogenous in SSA (there is much greater heterogeneity in the structural conditions).

With very few exceptions, IMF programs in Africa comprise quantitative targets for monetary aggregates, net international reserves, government domestic borrowing and non concessional external borrowing. These are the key targets in an IMF program; in practice, it appears that the structural conditions are accorded less importance.

One can argue that the quantitative targets are well suited to a certain type of economy facing specific challenges; notably a low income economy with a very shallow financial sector, inadequate international reserve cover and for which the key macroeconomic challenge is to restore macroeconomic stability after a period of severe macroeconomic turbulence. This was the situation on Uganda in the 1990s (as well as many other SSA economies at that time) and still applies to some countries in SSA today.

However, the economic situation in several SSA countries has evolved radically in the last two decades and they face very different macroeconomic challenges to those faced 20 years ago. Approximately a fifth of SSA economies, comprising about 50 percent of the region's GDP excluding South Africa, are now described as "frontier markets". The frontier markets are characterized by strong private sector led economic growth and financial sectors which are beginning to attract investment from abroad. They are starting to acquire similar economic characteristics to the emerging markets of Latin America and Asia.[3]

The key macroeconomic challenge for these economies is no longer to restore macroeconomic stability; many achieved this in the 1990s (they are mature stabilizers in the ergot of the Policy Support Instrument). Most have a good record of macroeconomic management over many years. In the years leading up to the global economic crisis, good macroeconomic management created the fiscal and macroeconomic space which enabled them to adopt countercyclical macroeconomic policies to offset the contractionary impact of the external shocks they faced as a result of the global crisis.[4] In many respects the response of some SSA economies to the global economic crisis was not very different from that of emerging market economies in other continents.

The post crisis global environment will probably be more volatile than it was prior to the global crisis, as the large global imbalances unwind, exacerbating shocks to SSA's external terms of trade and capital flows. The primary challenge for macroeconomic management in the frontier markets of SSA in the post crisis world will be to steer the economy with minimum volatility to prices and output in the face of domestic and external shocks emanating from

3 Nellor (2008).

4 Kasekende, Brixiova and Ndikumana (2010).

both the supply and demand side of the economy. This has two important implications for the reform of macroeconomic management. First, macroeconomic policy must include an element of short term aggregate demand management, something which is relatively new in most SSA economies. Second, it must recognize that there are multiple macroeconomic targets and hence potential tradeoffs; output stabilization and inflation for example.

How relevant are the macroeconomic conditionalities in IMF programs to the challenges facing macroeconomic management in the frontier markets of SSA? Arguably, all of the main quantitative targets in IMF programs are deficient.

Fiscal targets

The main quantitative target pertaining to fiscal policy in IMF programs in SSA is government net domestic borrowing. As a fiscal target this has three drawbacks for a frontier market. First, with the deepening of domestic financial markets in these countries, 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. Third, it provides only a partial indicator of the stance of fiscal policy – its impact on aggregate demand – which is what matters for macroeconomic management.[5] 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.

Monetary aggregates

Monetary aggregates as targets for monetary policy are an effective tool for bringing down inflation from high levels (which was a priority in the 1990s), but they are much less useful for controlling inflation when it is already at low levels, because of the instability of money demand.[6] Monetary targets are also an impediment to the more activist, discretionary, monetary policy which is needed to meet the challenges facing macroeconomic management in the frontier markets. Some form of an inflation targeting lite monetary policy framework is better suited to meeting these challenges; a monetary policy framework which has been adopted by many emerging market central banks. Retaining monetary targets in IMF programs is an obstacle to the progressive reform of monetary policy in SSA.

Floors on net international reserves

Targets for international reserves are clearly needed for countries facing BOP crises in which protecting the international reserves from further depletion is a policy priority. But it is difficult to understand why such targets should be accorded the same priority for countries which have accumulated large holdings of international reserves, equivalent to five or six months of imports and which face no immediate threat to their BOP. In these circumstances the targets constrain the country’s capacity to use its own foreign exchange reserves for purposes of exchange rate management. Exchange rate policies should be determined on their merits, not as a by-product of an IMF program target which is intended for an entirely different purpose.

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[5] For example, Government spending from external grants and loans can make a substantial contribution to the fiscal stance without affecting net domestic borrowing.

[6] Thornton (2008).

Non concessional external public borrowing

IMF programs in SSA impose limits (in some cases, zero) 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 they should not be retained indefinitely for many years after a country has received debt relief (under HIPC and/or MDRI) and is not at risk of external debt sustainability.

There are important benefits to be gained by SSA countries from accessing commercial debt markets. 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. Commercial borrowing entails fewer conditionalities and lower transactions costs than borrowing from the traditional donors. Furthermore, SSA Governments need to obtain and maintain a good sovereign credit rating from the rating agencies in order to access commercial bond markets. This provides a powerful incentive to policymakers to pursue sound macroeconomic policies.

Instead of ceilings on non concessional external public borrowing, it would be preferable to establish an overall public debt to GDP ratio as a medium term fiscal anchor, based on agreed debt sustainability criteria. Public debt should include both external and domestic debt, so that governments can choose the optimal balance within the overall debt sustainability constraint. If the debt/GDP ratio was expressed in terms of the net present value of debt, countries could then choose between contracting concessional debt or a lower amount of commercial debt. This would ensure that the key policy objective of maintaining fiscal sustainability is met but leave governments free to manage the composition of their borrowing according to their own preferences.

Should SSA countries consider more heterodox policies?

Successful emerging market economies have often employed an eclectic range of economic policies, in areas such as exchange rate management and financial sector policy. Policymakers in SSA can learn from their experience. This experience suggests that there is scope for expanding the set of feasible policy choices available in SSA. I will highlight three examples.

Exchange rate management

The exchange rate is a very important price in developing economies, which shouldn’t be ignored by macroeconomic management. It matters for inflation, output and financial stability, all of which are policy objectives.

Many emerging market central banks manage their exchange rates to some extent, without necessarily pegging the rate, because exchange rate movements can have severe adverse macroeconomic effects.[7] For example, several Latin American countries are currently trying to push down the value of their currencies because the recent appreciation has badly affected their competitiveness.

External shocks transmitted through the exchange rate may become more pronounced in the frontier markets of SSA as their economies become more integrated into global financial markets. Hence managing exchange rates will become more important for macroeconomic management. This does not mean that managing the exchange rate should take precedence over all domestic policy objectives; rather central banks should recognize that optimal macroeconomic management can encompass balancing multiple objectives rather than an exclusive focus on a single objective.

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[7] Calvo and Reinhart (2002).

Capital controls

Emerging markets are starting to take a more favourable view of the costs and benefits of capital controls, especially controls on short term portfolio capital flows, as a tool for both macroeconomic management and financial stability. This is for two reasons. First, even for economies which are capital scarce, the developmental value of short term portfolio capital flows appears tenuous. Second, exchange rate volatility triggered by inward or outward capital surges can be very disruptive to the real economy and the banking sector, especially if domestic agents have foreign currency liabilities.

The main drawback of capital controls is that they are often not very effective, because private agents find ways to circumvent them if the incentives are strong enough. Nevertheless, this is not sufficient reason to eschew their use entirely; even if capital controls are only partially effective they could still prove useful for stabilizing the economy and mitigating risks to the financial sector, as a complement to other policy tools.

Industrial policies

Industrial policies, broadly defined, have acquired, justifiably, a bad reputation in SSA. When they were used, mainly in the 1970s and 1980s, for the most part they failed badly for political economy reasons. But in other parts of the world, notably in East Asia, industrial policies have been more successful, and we should try and learn lessons from this experience.[8]

The alternative of laissez-faire economic policies, while it has been successful in many respects in SSA, has also failed in one crucial area. Laissez-faire policies have not brought about anywhere near enough private investment in modern industries to create large scale employment and accelerate the structural transformation of SSA economies. In most SSA economies the majority of the labour force still earns their living outside of the modern sector of the economy.

We need to reconsider whether public policy should not play a more active role in guiding resource allocation in the economy; specifically to stimulate private investment in labour intensive modern industries. Policies will need to be carefully designed to mitigate the risk of "government failure" (for example as a result of rent seeking), but that is not a reason for not attempting to design and implement feasible industrial policies which can meet the developmental needs of SSA.

Should SSA countries implement IMF programs over the long term?

As already noted, many SSA countries have been implementing successive IMF programs for up to two decades, even though they have no need to borrow from the IMF and don't face BOP problems. Is this still optimal? It is certainly not without costs, which go beyond any problems with the technical design of IMF programs already discussed.

There appear to be two reasons why SSA countries which don't require emergency support for their BOP still implement IMF programs. First, the IMF provides an external "agent of restraint" to protect the macro economy from the short sightedness of domestic politicians and bureaucrats who might otherwise implement excessively expansionary macroeconomic policies if left to their own devises. Second, budget support donors sometimes demand the imprimatur of an IMF program as a condition for disbursing their aid. Neither reason is entirely convincing.

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8 Rodrik (2009).

If SSA countries really need external agents of constraint, there are viable alternatives to IMF programs. Many SSA countries seek sovereign credit ratings on a regular basis, for which sound macroeconomic policies are imperative. Arguably, the fear of a very public downgrade of a sovereign credit rating is a much more powerful incentive for sound macroeconomic policy than the fear of an IMF program going off-tack, as the latter is subject to at least some degree of negotiation between the authorities and the IMF, with both sides anxious to avoid this outcome if possible.

In addition, regional institutions such as the East African Community have developed macroeconomic targets to promote eventual monetary union, which their members are committed to complying with. In terms of supporting sound macroeconomic management, the convergence criteria of the EAC – which include targets for international reserves and fiscal deficits – are not inferior to the targets in IMF programs. Hence, it is not clear why we still need IMF programs as agents of constraint for macroeconomic policy. As for the budget support donors, whether they would really cut their aid if IMF programs were no longer implemented in SSA is debatable. In any case, donor aid is becoming less important as a source of budget funding for the frontier markets.

There are also drawbacks to long term IMF involvement in SSA which should not be underestimated. In particular there are political costs. IMF conditionalities generate resentment in SSA because they are perceived as an affront to national sovereignty. For countries which only gained independence less than 50 years ago this sentiment is understandable. While policy conditionalities can be considered a necessary evil for countries which need to borrow from the IMF, it is hard to justify them politically when no borrowing from the IMF is needed.

Unfortunately this means that many sound economic policies become tainted by association with unpopular conditionalities, which makes a rational debate about economic policy harder to conduct in developing countries. If the IMF was not perceived to be imposing economic policies on a sovereign state, it might find a more receptive audience for the policy advice it provides through the Article IV consultations or Technical Assistance missions.

Withdrawing from long term engagement through non lending programs would allow the IMF to re-focus on providing emergency liquidity support to SSA countries facing BOP crises. If the external economic environment remains volatile, it is likely that there will be many instances where individual SSA countries will need temporary assistance to support their BOP. The IMF should work to strength its modalities for extending emergency liquidity assistance, so that it can be provided more rapidly and flexibly whenever the need arises. The IMF should collaborate with other international and regional financial institutions, such as the African Development Bank, to put in place an effective liquidity support mechanism to meet the needs of SSA countries.

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