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The Macroeconomic Implications of MDG-Based Strategies in Sub-Saharan Africa[1]

By John Weeks and Terry McKinley

I. Introduction to MDG-Oriented Macroeconomic Policies

At the Gleneagles summit in 2005, the G-8 committed to doubling Official Development Assistance (ODA) to Africa by 2010 in order to help finance national efforts to reach the Millennium Development Goals (MDGs). Will such a substantial scaling-up of ODA lead to more expansionary macroeconomic policies? This Policy Research Brief assesses the implications for fiscal, monetary and exchange-rate policies.

Photo: Andrew Mogridge.

Despite a recent upsurge of export-driven growth in sub-Saharan Africa, macroeconomic policies remain focused on maintaining macroeconomic stability. The prevailing neoliberal economic model relies on market forces to drive development. This implies fiscal policies preoccupied with small deficits, monetary policies fixated on low inflation targets and exchange-rate policies committed to full flexibility.

Such policies are unlikely to accelerate growth and broaden its impact to the extent necessary to halve extreme income poverty by 2015 (i.e., achieve MDG #1) and support the attainment of the other MDG targets for human development. So, is there an alternative economic model that could be successful?

This Policy Research Brief advances an alternative that entails three major changes in macroeconomic frameworks: 1) fiscal policies should become more expansionary—focusing on expanding public investment—and more intent on raising domestic revenue; 2) the exchange rate should be managed in order to promote export competitiveness and currency stability; and 3) monetary policy should accommodate fiscal expansion and export promotion, achieving low real rates of interest that promote private investment and alleviate public-sector debt.

Because policymakers in sub-Saharan Africa have operated under the binding constraints of a neoliberal economic model, the region's growth performance still lags behind the rates necessary to attain the MDGs, despite fortuitous external factors. Figure 1 (next page) illustrates the growth performance during 1985-2005 for three groupings of countries in the region: conflict-affected countries (10 countries), non-conflict middle-income countries (7) and non-conflict low-income countries (24).

The recovery of conflict-affected countries since the mid-1990s has led to the misleading impression of significant improvement in the whole region. However, middle-income countries have been doing worse during this period and improvements in low-income countries have been only modest.

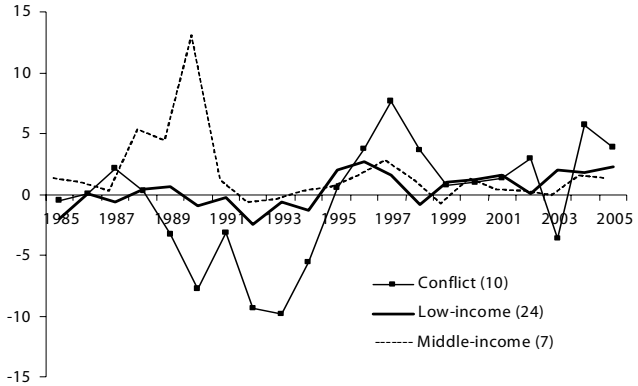
For the low-income group of 24 countries, growth of income per person averaged a mere 0.2 per cent during the 1990s and rose to only 1.2 per cent during 2000-2005. This lacklustre performance underscores the need for more expansionary, investment-focused macroeconomic policies.

II. Fiscal Policy: Expansionary and Public-Investment-Focused

Conditionalities imposed by stabilisation and structural adjustment programmes have compelled governments to try to achieve very low fiscal deficits, as well as low inflation rates. So, rarely have fiscal policies been growth-conducive (see Weeks and Patel 2007).

The obsession with low deficits has been misaligned with the fiscal conditions prevailing in sub-Saharan Africa. Evidence for 30 countries for which the IMF reports relevant statistics shows that large fiscal deficits (i.e., over five per cent of GDP) have not been widespread. Over the period 1985-2005, never more than one fourth of these countries had a larger deficit at any one time. In all years during this period, at least half the countries had a deficit below three per cent.

Figure 1
Annual Growth Rates for Sub-Saharan African Countries by Category, 1985-2005



Notes: Conflict countries are Angola, Burundi, Chad, DRC, Ethiopia, Liberia, Rwanda, Sierra Leone, Sudan and Zimbabwe.

Source: World Bank, *African Development Indicators 2006, and* <http://www.imf.org/external/pubs/ft/weo/2007/01/data/weoselgr.aspx>.

What is the purpose of running deficits? One is to compensate for economic downturns. The movements of both revenues and expenditures are tied to the economic cycle: revenues fall when private income falls but social expenditures need to rise in order to compensate for income losses. Thus, insisting inflexibly on maintaining low deficit targets renders fiscal policy 'pro-cyclical' (i.e., government spending falls when private incomes drop). This makes downturns worse.

Running deficits has a more development-relevant objective: borrowing to finance public investment in essential economic and social infrastructure. Without extensive public investment, attainment of the Millennium Development Goals would not be possible. Widening deficits for such a purpose should be, in fact, a regular fiscal practice, and largely funded, over the medium term, by concessional external finance.

But governments should concentrate, over the longer term, on mobilizing more domestic revenue for financing development, instead of resorting to domestic or external debt. Even relying indefinitely on external grants has drawbacks since it could dampen incentives to raise domestic resources.

Recent efforts to raise revenue have been anaemic. From the early 1990s to the early 2000s, revenue as a ratio to GDP has risen only from 14.1 per cent to 15.9 per cent in low-income countries in sub-Saharan Africa (McKinley 2007a and 2007b).

A doubling of such an increase, i.e., to four percentage points of GDP over 10 years, is needed to begin graduating governments from reliance on Official Development Assistance for financing MDG-focused public investment. In order to achieve such a target, governments will need to adopt a more ambitious, diversified approach to mobilizing domestic resources, relying pragmatically on all major sources of revenue, i.e., domestic indirect taxes, direct taxes and trade taxes.

III. Exchange Rate Policy: Managing for International Competitiveness

While stabilisation and structural adjustment programmes were rendering fiscal policies passive and deficit-phobic, they were also converting a previously active management of the exchange rate into a non-interventionist, *laissez-faire* regime. The justification was that governments in the sub-Saharan region were supporting over-valued exchange rates.

But the effects of such neoliberal reforms have been counter-productive. Contrary to expectations, non-intervention has led to increased volatility of nominal exchange rates, often precipitated by transitory external 'shocks', such as international price changes or manipulation by large traders in narrow currency markets (see Weeks et al. 2007). Moreover, a substantial proportion of foreign exchange flows in and out of sub-Saharan Africa—namely, Official Development Assistance and remittances—tend to be unresponsive to exchange-rate movements.

In the small open economies prevalent in the region, exchange-rate volatility has gravely jeopardized macroeconomic stability. It was the prevalence of such market dysfunctions before the 1980s that motivated, in fact, the original adoption of exchange rate management.

As the prices of some primary products, especially petroleum and minerals, have risen in the 2000s, exchange rates have appreciated in some countries. Under such conditions, exchange-rate management becomes critical, particularly in order to foster the international competitiveness of non-primary exports, such as manufactures.

Avoid Inflation Targeting

But inflation-targeting monetary policies make such management exceedingly difficult. IMF conditionalities have often placed restrictions on money-supply growth. If central banks purchase foreign exchange (and correspondingly sell domestic currency) in order to counteract currency appreciation, the domestic money supply will grow.

In response, central banks often sell government securities ('sterilize') in order to mop up liquidity. But sterilization ends up cancelling the potentially positive effect of the original infusion of domestic currency. Frequently, domestic interest rates rise. In some cases, portfolio inflows surge into the economy to speculate on the currency appreciation, particularly if it is driven by a commodity boom. This only exacerbates the pressures for appreciation. Open capital accounts (which have commonly accompanied a *laissez-faire* exchange-rate regime) heighten such volatility.

While exchange-rate management is inconsistent with inflation targeting, it is complementary to monetary policies that accommodate expansionary, investment-focused fiscal policies. Exchange-rate management can neutralize inflationary pressures arising from rising investment demand or terms-of-trade shocks. An example of a terms-of-trade shock is a jump in oil prices for an oil-importing developing country.

In general, exchange-rate management is essential for: 1) maintaining short-term stability of the nominal exchange rate, which can reduce private-sector uncertainty and facilitate public-sector budget planning; and 2) achieving a real exchange rate in the medium term that can foster broad-based export competitiveness and structural diversification of the economy.

Achieving the first objective is extremely important in sub-Saharan Africa because of the lack of private-sector mechanisms that can hedge against exchange-rate risk. In

practice, only large enterprises can afford to hedge effectively, typically through foreign financial intermediaries. So, regular short-term central bank intervention to manage exchange-rate risk could spread the social benefits more broadly, particularly among medium and small enterprises.

Achieving the second objective, competitiveness, is a strategic priority, particularly for countries with a high export concentration but low export diversification. These features characterize many low-income countries in sub-Saharan Africa. Managing the exchange rate should strive for a real rate that is not only relatively stable but also, if possible, slightly undervalued in order to favour tradable goods, both exports and import substitutes. This would help hasten the diversification of the economy and progressively boost overall productivity.

IV. Monetary Policy: Supporting Fiscal Expansion

The policy of the orthodox framework that is perhaps most detrimental to expanding investment to achieve the MDGs is 'inflation targeting'. In its most inflexible form, it mandates the central bank to target an inflation rate below a low threshold. Until recently, that level was often five per cent or below. The instrument deployed to 'hit' the target has almost always been the nominal interest rate. In practice, fulfilling such a mandate has overridden all other policy objectives, whether they be growth, employment or export promotion.

Since this framework assumes that every economy gravitates towards general equilibrium, it believes that inflation has no structural cause. It is usually assumed to arise from extraneous factors, such as 'random shocks' or people's expectations. Ultimately, the government is blamed—usually because of excessive spending—for fuelling continuous expectations of rising inflation.

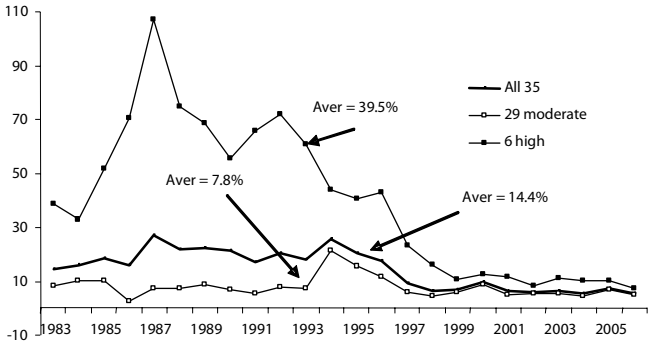
Strict inflation targeting is bound to fail in sub-Saharan Africa because of large, unpredictable swings in prices. For illustration purposes, assume an inflation target of five per cent. During 1980-2000, the average annual terms-of-trade shock across 42 countries in sub-Saharan Africa was 4.5 per cent of GDP, with a large standard deviation of 5.4. Since the average economy in the region has a trade sector (combining export and import shares) that is one-third of GDP, the likely result is to produce, half the time, an external price 'shock' of 1.5 per cent (1/3 of 4.5).

This implies that yearly economy-wide price changes due to non-tradables would have to be confined, at least, to only 3.5 per cent (5.0 – 1.5) in order for inflation to stay, half the time, under an overall five per cent threshold. But since the standard deviation (5.4) for the external price shock is so large, the target for the price effect of non-tradables would have to be set much lower than 3.5 per cent.

Since labour is a large input into non-tradables, real wage increases would also have to be contained. This would lead to a policy bias towards maintaining high nominal interest rates in order to contain the aggregate demand pressures that could fuel inflation.

But inflation has not, in fact, been a grave problem in sub-Saharan Africa. The calculations for Figure 2 divide countries in the region into three groups: three hyper-inflation countries (Angola, the Democratic Republic of Congo and, in the 2000s, Zimbabwe (which are excluded from the figure)), six inflation-prone countries, and 29 countries with only moderate inflation.

Figure 2
Inflation Rates for Sub-Saharan African Countries, 1983-2006



Notes: See endnotes number 2.

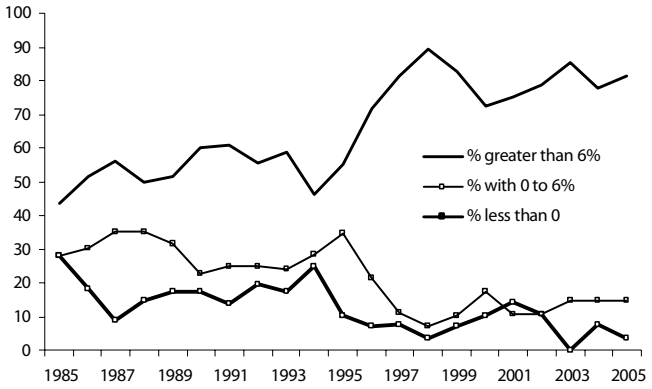
Source: IMF. <http://www.imf.org/external/pubs/ft/weo/2007/01/data/weoselgr.aspx>.

Since 29 countries have had an inflation rate of less than 10 per cent two-thirds of the time and have maintained a long-run average of less than eight per cent, restrictive monetary policies obsessed with price stability do not appear justified. There is little convincing evidence, in fact, that moderate inflation, i.e., 5-15 per cent (if not higher), retards growth. If inflation becomes a problem because of adverse supply shocks (such as rising food or oil prices), domestic measures, such as maintaining food buffer stocks or subsidizing public transportation, could mitigate its impact.

Moreover, there was a convergence of inflation in the six high-inflation countries to the level of the moderate-inflation countries by 1999. This convergence across countries of different sizes, economic structures and past performances suggests that underlying inflationary pressures have declined in recent years for the entire region.

The continuing misguided effort to maintain low inflation rates is reflected in the trends in real rates of interest depicted in Figure 3. Shown for 1985-2005 are the percentage of countries with real interest rates exceeding six per cent, the percentage with real rates ranging between zero and six per cent, and the percentage with negative real rates.

Figure 3
Real Interest Rates: Percentage of Countries by Range, 1985-2005



Source: World Bank, *African Development Indicators, 2006.*

A six per cent real rate of interest is a high-end estimate for the so-called 'Golden Rule'. This states that the long-term real rate of interest should not exceed the maximum sustainable rate of growth of real income per capita. If the interest rate did exceed such a threshold, it would hamper growth.

For the first ten years of the entire period 1985-2005, about half of the countries had real interest rates above the 'Golden Rule' level. After 1997, the average was 80 per cent. This signified that four out of five countries had real interest rates that likely constrained economic growth.

Furthermore, negative interest rates, which had been heavily criticised in the orthodox adjustment literature, were overwhelmingly a problem of only a few conflict-affected, hyper-inflation countries. For example, for the 23 instances of negative real interest rates during 1997-2003, 18 were confined to the three countries of Angola, DRC and Zimbabwe.

If monetary policy were liberated from the straight-jacket of inflation targeting, it could contribute to the accelerated growth and human development necessary to attain the MDGs. Its main contribution should be to support expansionary fiscal policy. If inflationary pressures are moderate, this support would generally take the form of promoting positive but low real interest rates and ensuring an adequate expansion of the money supply.

A major obstacle to effectively implementing MDG-based macroeconomic policies is the underdevelopment of financial institutions and, in some cases, the low monetization of the economy in sub-Saharan Africa. This helps explain why governments have difficulties in selling securities to the domestic financial sector. Because they often have to pay high real rates of interest, their debt burdens are worsened. Even when real rates of interest have started to decline, the spread between deposit and lending rates of interest have frequently remained wide. In a forthcoming companion Policy Research Brief on MDG-oriented financial policies, we will examine such issues.

V. Concluding Remarks

A macroeconomic framework oriented towards achieving the MDGs does not have to be discovered: it is known and it is feasible. Fiscal policy should be expansionary and focused on financing wide-ranging public investment; exchange rates should be managed in order to maintain short-run price and currency stability and foster long-term competitiveness and diversification of the economy; and monetary policy should accommodate fiscal expansion instead of restricting it through the targeting of unreasonably low inflation rates and correspondingly high real rates of interest.

Such a framework would allow macroeconomic policies to be aligned with a national MDG-based strategy focused on accelerating investment, economic growth and human development. Over the longer term, such an orientation would also imply a greater reliance on mobilizing domestic development finance instead of banking indefinitely on Official Development Assistance, which has often been unreliable, if not volatile.

In recent years, as net ODA has begun to rise, there has been a greater emphasis on policy coordination—particularly between fiscal policies and monetary policies but also between these two and exchange-rate policies. However, restrictive inflation-focused monetary policies have held sway over the other two.

The terms of such coordination have to be transformed in order to be consistent with an MDG orientation. Monetary policies have to be tailored to accommodate fiscal expansion, fostering, in particular, affordable public investment. They also have to support exchange-rate management for export competitiveness instead of undermining it by rigidly targeting low inflation rates. ■

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2. High Inflation (6) – Countries with an average inflation over 30 per cent for the entire period (Ghana, Guinea-Bissau, Mozambique, Sierra Leone, Sudan and Zambia); Moderate Inflation (29) – Countries with an average inflation of about eight per cent for the entire period; All (35) – The average for the countries in both categories. Omitted because of hyperinflation: Angola (average 604 per cent), DRC (1,588 per cent) and Zimbabwe (390 per cent for 2000-2006).

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