

How Fiscal Policies in Africa Can Respond to The Global Financial Crisis

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Initially, low-income countries in sub-Saharan Africa were hopeful of escaping the brunt of the global financial crisis because of the underdeveloped nature of their financial systems. The emerging evidence indicates, however, that they are experiencing a sharp downturn. So, how can policymakers in the region respond? This Development Viewpoint focuses on the options for counter-cyclical fiscal policies (see Weeks 2009).

Historical evidence suggests that a one percentage point change in the growth of OECD countries is associated with a 0.42 percentage point change in the growth of countries in sub-Saharan Africa, with a one-year lag. Since there has been widespread recession in developed countries, the above correlation indicates that growth in sub-Saharan Africa could drop to about 3% in 2009 and 1% in 2010—from a previous peak of 6% in 2007.

In response to such a prospect, policymakers in Africa have two basic options. One, they could continue with pre-crisis 'business-as-usual' macroeconomic policies. These would continue the focus on preventing inflation, targeting small budget deficits and allowing flexibility of the exchange rate. Adopting this stance has to be based on the crucial assumption that the rich countries would soon resume robust rates of growth.

However, choosing such an option—as Dr Johnson said of second marriages—would represent the triumph of hope over experience. When the world economy is deflating (and full recovery is unlikely soon), implementing a fiscal policy guided by fears of inflation would result in a contraction of domestic demand, compounding the current severe contraction of exports.

In addition, targeting a small fiscal deficit is becoming increasingly difficult because of falling tax revenues. If the government attempts to correspondingly reduce public expenditures, domestic growth will decline even further. Moreover, if the central bank allows the nominal exchange rate to sharply depreciate (because of rising trade deficits), imports will become more expensive and thereby aggravate inflation.

Alternative Fiscal Policies

What is the alternative? Use counter-cyclical fiscal policies to compensate for the fall in domestic and external private demand. Though such Keynesianism has been out of fashion for some time, it has now suddenly come back into favour in the developed world.

Multilateral and regional financial institutions, such as the IMF, World Bank and the African Development Bank, have begun endorsing counter-cyclical fiscal policies for the developing world. In January 2009, for instance, the IMF called for a 'firm commitment to a timely implementation of fiscal stimulus across a broad range of advanced and emerging economies' and by May it had recommended such an approach, for the first time, for a low-income country, i.e., Mozambique.

But how should developing countries in Africa implement such an approach? For example, which is better: lowering taxes or raising public

expenditures? Taxes are a clumsy instrument for demand management. First, approving new rates or instituting new taxes is likely to take time. There is also likely to be a higher multiplier impact for increasing public expenditures since savings from lower taxes might not be fully spent.

Generally, current expenditures are better suited than capital expenditures for counter-cyclical stimulus to an economy. Capital projects take more time to initiate (as well as more time to discontinue if an economy were to start over-heating). Capital expenditures are better suited to raising the growth potential of an economy whereas current expenditures are better suited to addressing shortfalls in demand that hold back realizing such a potential.

Exceptions to this rule are 'labour-intensive public works', which the International Labour Organisation has pioneered. Examples of such activities are repairing public buildings, digging sanitation ditches or clearing rural footpaths. Such temporary projects have low capital content, pay mostly wages and can be easily initiated and quickly terminated.

Financing Fiscal Deficits

If governments in sub-Saharan Africa run larger deficits as a result of implementing counter-cyclical fiscal policies, how can these be financed? One option is to press for greater donor support, building on the MDG consensus. But donor funding is not easily adapted to financing counter-cyclical expenditures since it follows a fixed schedule of allocation and disbursement.

An alternative is to encourage donors to set up an 'aid fund', whose monies, once established, could be drawn on quickly during a crisis. During periods of economic growth, in contrast, such monies could be built up.

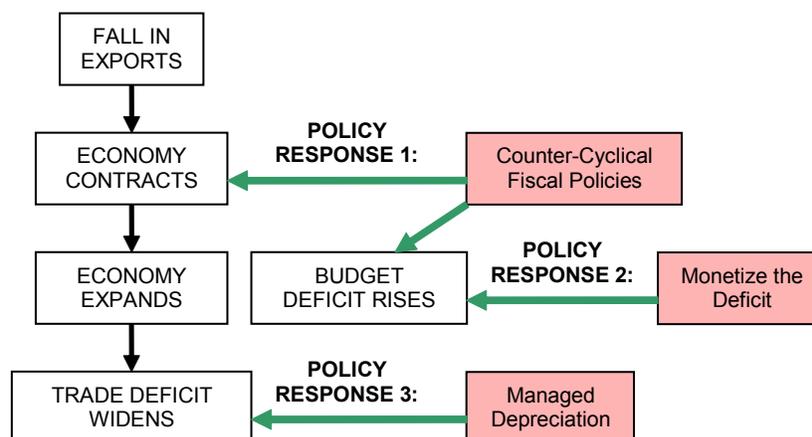
However, as a practical matter, implementing a counter-cyclical fiscal stimulus in most countries in sub-Saharan Africa will have to be largely funded by domestic public-sector borrowing. If the associated deficit were to exceed a level consistent with other policy objectives, such as containing inflation, then donor funds should be sought to finance the shortfall.

Since economies in the region are operating well below full potential, there will be little danger that increases in public expenditures would crowd out private expenditures. In fact, deficit spending should stimulate more private spending. But how the deficit is financed might influence the impact on inflation.

In theory, the government could sell bonds to the private sector. There would be no effect on inflation since the net effect on the money supply would be zero. While the bond sale would siphon money out of the economy, the corresponding increase in public spending would inject the same amount back into it.

But if the domestic bond market is shallow—as is often the case in low-income countries—then the government might have to offer a high real rate of interest to buyers, which are usually domestic commercial banks.

Policy Options to Deal with the Current Global Financial Crisis



The resultant rise in the borrowing rate of interest might deter private businesses from securing loans from these banks.

So some 'crowding out' of productive private investment might indeed occur. And, in the process, the government would have to pay higher servicing costs for its public debt.

In contrast, borrowing money from the central bank, or 'monetising the deficit', can be an effective tool for expanding aggregate demand, without necessarily generating significant inflation or causing 'crowding out' of private expenditures (see chart). This assumes that the economy is operating below full capacity.

Monetising the deficit would generate an increase in the money supply that should be sufficient to circulate the additional output of goods and services that results from the increase in public expenditures. Hence, there is no major technical argument against financing a fiscal stimulus through borrowing money from the central bank.

Exchange-Rate Management

When expansionary fiscal policies are used to combat recession, there will likely be pressures to depreciate a country's exchange rate. The core reason is a likely expansion of a country's trade deficit as the rise in incomes prompted by fiscal expansion is translated into higher imports.

The likelihood of such an outcome dictates that exchange-rate adjustments should be carefully managed. This stance contrasts with a regime of flexible exchange rates, in which the value of the currency is fully exposed to volatile market forces. Such a regime, though widely advocated by mainstream economists, is ill-suited for most low-income countries.

Without exchange-rate management, an abrupt and substantial

depreciation would precipitate a potentially sharp rise in the domestic price level as imports become more expensive in domestic currency terms.

The purpose of maintaining a managed exchange-rate regime, such as a 'managed float' or a 'crawling peg', is not to eliminate depreciation but to control its rate and timing. The governing motivation is to prevent a country's currency from depreciating at a rate that invites speculative attacks and ends up generating unacceptably strong inflationary pressures.

Summary

In sum, we are recommending that policymakers in sub-Saharan Africa implement counter-cyclical fiscal policies, based on maintaining complementary management of the exchange rate and securing financing mainly through borrowing from the central bank.

Such an approach will require, of course, some degree of flexibility on the part of donors and the International Monetary Fund, particularly with regard to the government's inflation target. Obvious constraints are the magnitudes of any trade and fiscal deficits.

Many governments are likely to need additional grant financing in order to effectively combat the threat of recession. But, more importantly, they will need to be granted additional 'policy space'. This signifies that they should be relieved of abiding by unduly restrictive external conditionalities on public deficits and levels of inflation.

References:

Weeks, John (2009). "The Global Financial Crisis and Countercyclical Fiscal Policy," Key presentation at the 2009 African Caucus on "The Global Crisis and Africa: Responses, Lessons Learnt and the Way Forward", Freetown, Sierra Leone, 12-13 August. See [CDPR Discussion Paper 26/09](#). **This recovery plan is part of the Freetown Declaration, which was endorsed by the 2009 African Caucus of Finance Ministers.**