



Countercyclical Fiscal Policies in an EAMU: Challenges and Fiscal Framework Implications

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Key Messages

Fiscal Policy should not be procyclical in general. Fiscal Policy should play a stabilization role, especially when in an EAMU the national discretion over monetary and exchange rate policies would be lost. In practice, however, procyclical fiscal policies have been the norm in developing and African countries.

Fiscal rules, strong fiscal frameworks, stabilization funds, and transfer mechanisms may support countercyclical fiscal policies (CFPs). But, key elements are required:

- (1) Political commitment and public support for fiscal discipline;
- (2) Transparency and reputation regarding rules and fiscal discipline;
- (3) CFPs should be two-sided: smoothing output and employment during negative shocks (downturns) but also during positive shocks (upturns);
- (4) Provisions for the expansion of government budgets; and
- (5) A strong fiscal framework and timely and reliable government finance and real sector statistics.

Issues

- A. The role and limits of countercyclical fiscal policies
- B. Fiscal Rules: mechanisms to support fiscal sustainability, credibility and countercyclical fiscal policies (CFPs)
- C. Rules have different implications for the way fiscal policy responds to shocks
- D. Implication for the EAMU
- E. Challenges and Requirements for a sound Fiscal Framework in an EAMU that provides room for a CFP

A. Role and Limits of Counter-Cyclical Fiscal Policies

- Consensus among macroeconomists: Fiscal policy should not be procyclical in general: Fiscal policy should play a macro stabilization tool.
- Counter Cyclical Fiscal Policy (CFP) mechanisms:
(i) automatic stabilizers; or (ii) discretionary actions:
reduction (increase) of taxes or increase (reduction) in expenditure.
- CFP from the operation of automatic stabilizers is faster: not subject to implementation lags and more predictable than discretionary actions.

- Discretionary CFP actions need to be implemented quickly and withdrawn early, however, to minimize risks to debt sustainability. Risk of fiscal policy becoming procyclical.
- The procyclicality and deficit bias of fiscal policies has been a stylized fact in African countries and other developing countries for several technical and development reasons.
- Procyclicality has been asymmetric: deficits increasing in downturns but not falling in periods of high growth.
- The expansionary trends of government expenditure have been a key source of the deficit bias in government finances. The tendency to overspend temporary increases in fiscal revenues during good times.

- During 2009-11 many African countries adopted countercyclical fiscal policies in response to the global financial crisis: (supported by IMF programs).
- The role of a discretionary CFP is stronger when automatic stabilizers are weak as in East African countries. But effectiveness falls when fiscal multipliers are low
- Fiscal multipliers tend to be smaller in African and other developing countries: shallow financial systems and limited access to external financing.
- Automatic stabilizers are also weak because of technical and development reasons.
- So, the implementation of CFP for East African countries and the EAMU is not an easy task.

B. Fiscal rules: mechanisms to support fiscal credibility, sustainability and CFPs

- Fiscal rules can support fiscal discipline and the adoption of CFPs.
- Fiscal rules establish constraints on the government budget and provisions for the stabilization role of fiscal policy.
- In the case of the EAMU fiscal rules may help to avoid the procyclicality of fiscal policy and maintain fiscal discipline. But the task is not easy.

C. Rules have different implications for the way fiscal policy responds to shocks

- The effectiveness of fiscal rules that would help support a CFP in the EAMU should combine fiscal sustainability, flexibility, and a sound fiscal framework.
- Overall balance or debt rules are simple but provide low flexibility to output shocks.
- Budgets can be affected by interest rate and exchange rate movements: Primary balance rules do not require full adjustment to them.

- A cyclically adjusted or structural balance rule allows the full operation of automatic stabilizers, but does not provide room for discretionary fiscal stimulus. But difficult to apply in developing and poor countries.
- Rules “over the cycle” provide room for discretionary adjustments. But they require technical and forecasting capacities, and good national statistics.
- Expenditure rules are consistent with cyclical changes in tax revenues, but not for discretionary expenditure stimulus.
- Revenue rules do not allow the operation of automatic stabilizers on the revenue side and could induce fiscal procyclicality.

D. Implications for the EAMU

- Ideally, CFPs should be based on a structural balance framework: give good picture of the stance of fiscal policy and allow for the operation of automatic stabilizers.
- However, the role of CABs should not reduce the importance attached to the monitoring of nominal balances and debt dynamics.
- Rules based “over the cycle” and on the CABs also face the problem of identifying the cycles, policy lags, technical capacities, and national statistics: Key issues in East African countries.

- **Challenges for the EAMU:**
- Complicated fiscal rules based on the CABs or the “cycle” very difficult to implement.
- Easier to adopt and implement an overall balance rule but with mechanisms that allow CFP actions.
- An overall balance rule establishes direct link to the government debt. The rule should consider flexibility to adopt CFPs and control on the growth of government expenditure. Transparency and credibility are crucial.
- Big question for the EAMU: To target the government balance including or excluding foreign grants and natural resources.

- The government balance including grants measure debt accumulation and easy for monitoring and reporting.
- Strict adherence to a government balance target could, however, induce fiscal procyclicality in bad time and may mask unsustainable expenditure budgets.
- In an EAMU fiscal rules and the fiscal framework should ensure fiscal sustainability and include if possible some flexibility for the adoption of CFPs.
- But, provisions for CFPs should be clear, transparent and symmetric.

E. Challenges and Requirements for a sound Fiscal Framework that provides room for a CFP

- Effective implementation of fiscal sustainability and CFP actions should be supported by sound fiscal frameworks for monitoring and enforcing compliance with the fiscal objectives.
- Given the statistical constraints in the EAC the fiscal frameworks and associated fiscal and debt targets in an EAMU could relate to the level of the general government.
- However, government finance statistics require harmonization. This issue will be covered in more detail in the following presentations.
- Other monetary unions have created Fiscal Councils, Stabilization Funds, and Transfers mechanisms to implement CFPs.
- But, effective fiscal oversight and enforcement, and political commitment and public support are crucial for the sustainability of a monetary union (EU crisis).



Thank you