The Implications of East African Monetary Union for the Fiscal Management of Aid and Natural Resource Revenues

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February 2012

Background

Primary rationale for external constraints on fiscal policy (e.g. ceilings on fiscal deficits) is to ensure fiscal sustainability; avoid the danger of sovereign default

Fiscal rules applied at the regional level to ensure fiscal sustainability involve trade off between what is optimal for each country and what can be readily monitored, understood, enforced and command consensus

Fiscal sustainability could be threatened by:

a) excessive deficits in "normal times" leading to unsustainable growth of public debt,

b) adverse fiscal shocks (e.g. shocks to revenue, systemic events)

Hence fiscal rules should take account of the need to mitigate vulnerabilities to fiscal shocks, as well as ensuring sound fiscal policy in normal times

Fiscal policy must also avoid exacerbating , or causing, asymmetric macroeconomic shocks

Fiscal deficit rules in the EAC Convergence Criteria Stage II

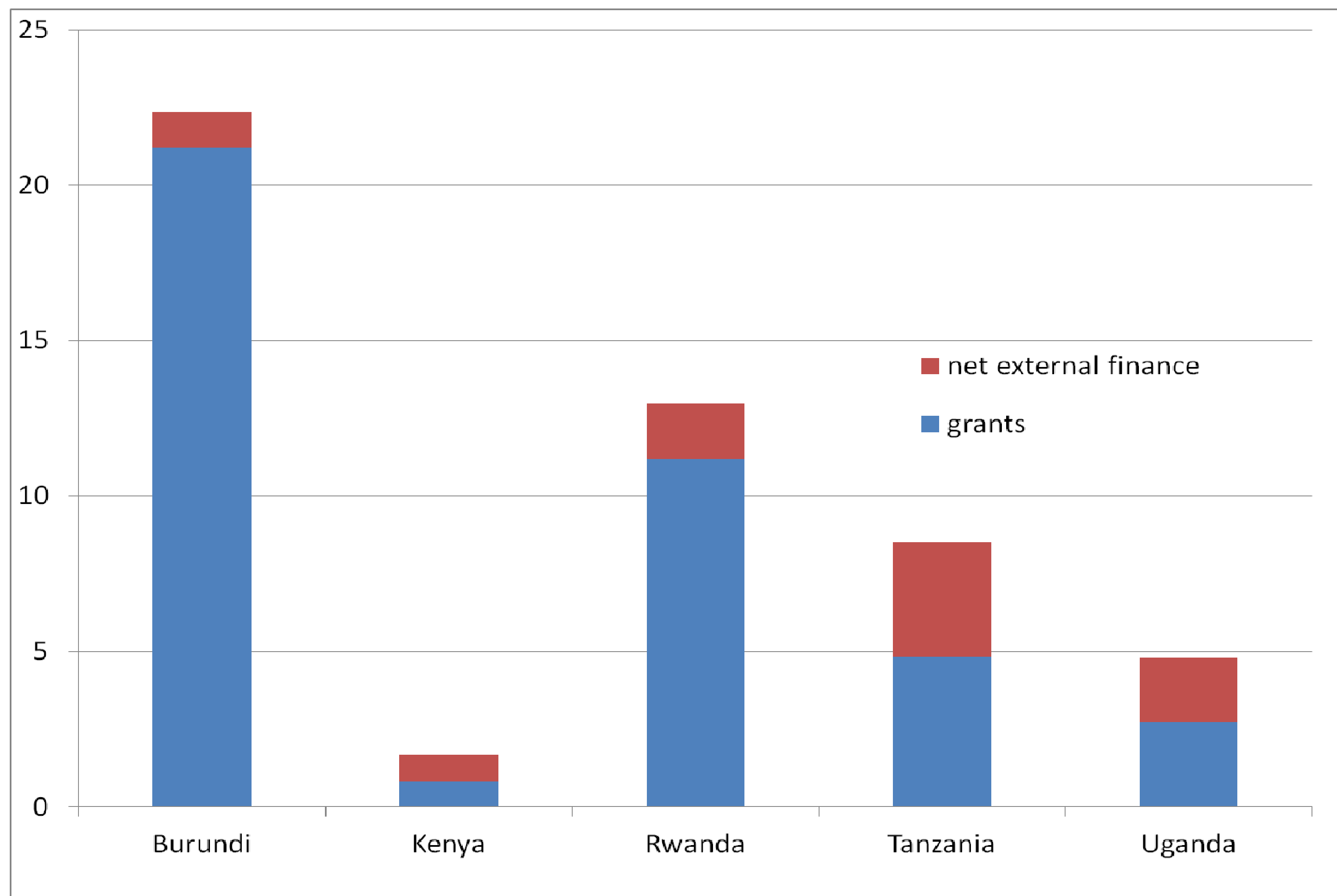
$R + G – E \geq - 2\%$ of GDP

$R – E \geq - 5\%$ of GDP

R = revenues, G = grants, E = expenditure & net lending

Fiscal deficit rules are identical for all partner states

Donor Aid to Government Budgets in the EAC: percent of GDP; annual average 2008/09-2010/11



Characteristics of Aid to EAC Governments

- The amount of aid received is very heterogeneous across partner states
- Most of the heterogeneity is attributable to differences in grants
- All partner states would have to reduce fiscal deficit before grants to comply with stage II deficit ceiling of 5% of GDP; required reduction is large for Burundi and Tanzania

Donor Aid to Government Budgets in the EAC: percent of GDP; 2008/09-2010/11

	2008/09	2009/10	2010/11
Burundi	19.2	24.4	23.4
ow grants	18.5	22.7	22.4
ow net external finance	0.7	1.7	1.0
Kenya	1.6	1.7	1.7
ow grants	0.9	0.8	0.7
ow net external finance	0.7	0.9	1.0
Rwanda	11.9	14.0	13.0
ow grants	9.3	13.2	11.0
ow net external finance	2.6	0.8	2.0
Tanzania	8.7	9.2	7.6
ow grants	5.1	4.6	4.7
ow net external finance	3.6	4.6	2.9
Uganda	5.4	4.7	4.2
ow grants	3.4	2.5	2.3
ow net external finance	2.0	2.2	1.9

Fiscal Balances before Grants, 2008/09-2010/11, percent of GDP

	2008/09	2009/10	2010/11
Burundi	-23.5	-26.4	-24.9
Kenya	-5.2	-7.4	-7.7
Rwanda	-11.5	-13.3	-14.5
Tanzania	-9.9	-11.6	-10.6
Uganda	-5.3	-7.3	-9.4

Should fiscal rules restrain fiscal deficits before grants?

Use of grant aid can contribute towards convergence in income levels/development within the EAC

But, heavy dependence on donor aid increases fiscal vulnerability, because aid disbursements are volatile and outside the control of the recipient government

Fiscal vulnerability concerns apply more to budget support, used to fund general budget expenditures, than to project aid for stand-alone projects

Options for reconciling conflicting objectives

1. Exclude only budget support grants from the fiscal deficit before grants ceiling;
2. Link the ceiling to a moving average of actual grant disbursements;
3. Require governments to set save a fraction of general budget support grants in a contingency fund held to be used as a buffer against unexpected aid shortfalls

Concessional loans

- Almost all external borrowing by EAC partner states over the last three years was on concessional terms
- Concessional loans pose less of a threat to fiscal sustainability than commercial loans, because of lower interest rates and longer maturities
- This should be reflected in fiscal rules; e.g. by including the grant element of a concessional loan in the computation of the fiscal deficit after grants

Implications of oil and mineral revenues

At least one EAC partner state is likely to become an oil producer

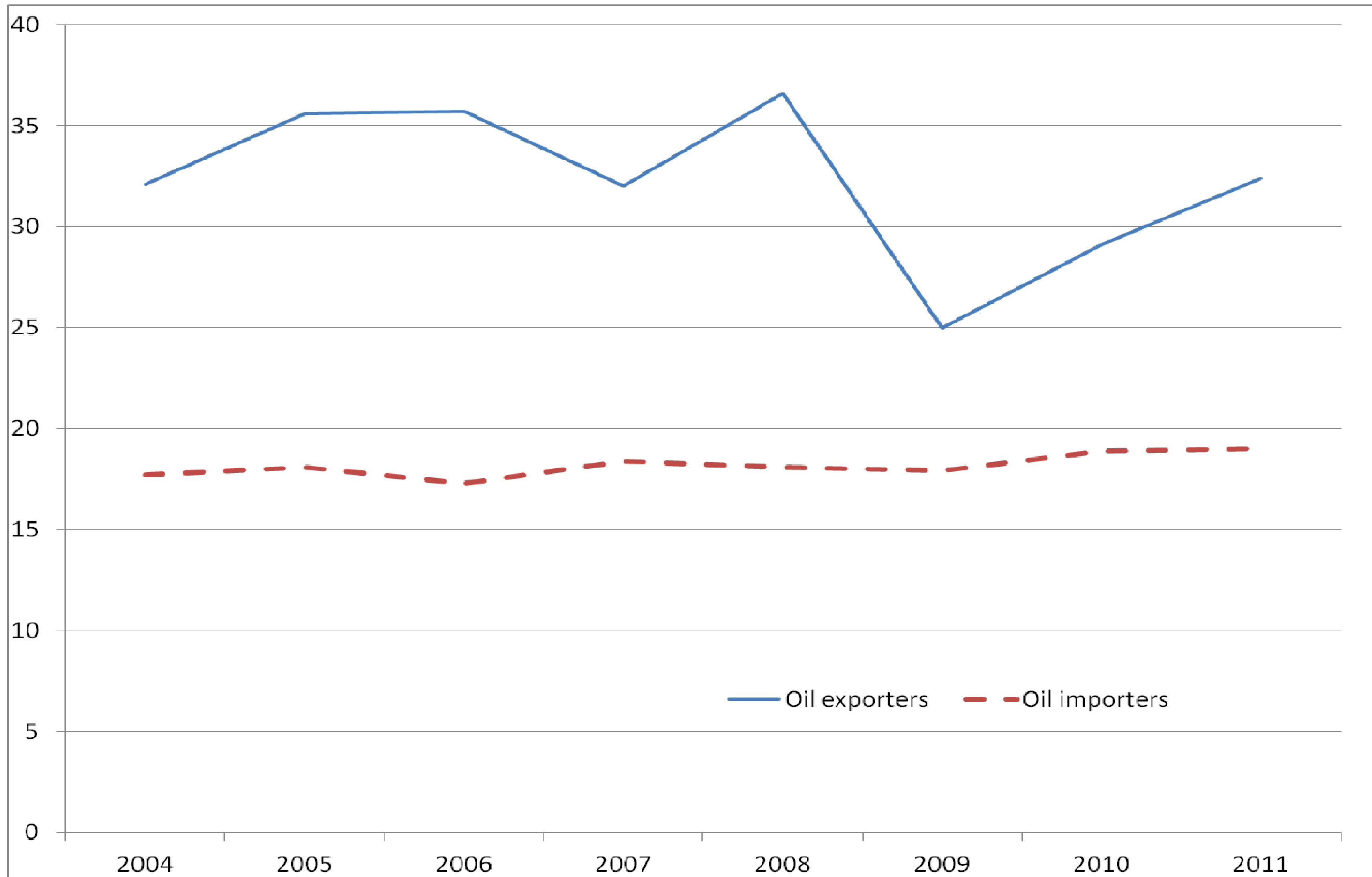
Oil and mineral revenues complicate fiscal management because:
  a) they are volatile in the short term (see next slide)
  b) their future value is very uncertain

Because the bulk of oil or mineral rents accruing to domestic residents are paid to the government as revenues, the main channel of transmission of oil related shocks to the domestic economy is via the government budget

Oil producers in developing countries have usually implemented pro-cyclical fiscal policy; fiscal policy has exacerbated macroeconomic instability

Oil shocks will be asymmetric between partner states if some are oil producers and others are not

Average fiscal revenues of oil exporters and oil importers in sub-Saharan Africa; percent of GDP, 2004-11



Implications of a conventional fiscal balance rule for an oil producer

- Targeting the conventional fiscal balance transmits oil revenue volatility to public expenditure
- Hence fiscal policy becomes procyclical – it will destabilise the macroeconomy
- Conventional fiscal balance is a poor indicator of fiscal stance in an economy which derives a large share of budget resources from abroad (e.g. taxing the export of oil)
- Optimal rule would de-link government expenditure from contemporaneous receipts of revenue; instead link it to long term sustainable revenue receipts; e.g. <u>Non oil fiscal balance</u>
- Hence a monetary union which includes both oil and non oil producers would have to consider applying different fiscal rules to the former than the latter

Implications for fiscal rules in the EAC

Oil or mineral producers

Subject to non resource revenue fiscal balance rule:

NRFB = NRR – E

Objectives:

i) insulate the budget and the macroeconomy from shocks to oil/mineral revenue

ii) Ensure fiscal sustainability

Countries without oil or minerals

Subject to conventional fiscal balance rule: R + G – E

Objectives:

ii) ensure fiscal sustainability

Relationship between the conventional fiscal balance rule and a non resource revenue fiscal balance rule

$FB = R + G – E$

$NRFB = NRR + G - E$

$FB = NRFB + SARR$

The non resource revenue fiscal balance rule applicable to oil/mineral producers should be lower than the conventional fiscal balance applicable to non oil/mineral producers by an amount equal to the annual sustainable long term use of resource revenues

Oil producers will have to convince their partners that the estimate of SARR really is sustainable

FB = fiscal balance, R = total revenues, G = grants, E = total expenditure & net lending, NRFB = non resource fiscal balance, NRR = non resource revenue, SARR = sustainable annual long term use of resource revenues