IGC International Growth Centre

General Summary for the 2012 IGC Workshops on Fiscal and Monetary Policy

The main goal of the 2012 Workshops on Fiscal and Monetary Policy was three-fold: first, follow-up on the issues that were raised in the 2011 workshops; second, present research that addresses some of those questions; and, third, discuss the degree of complementarity between the current research on monetary and fiscal policies in Low Income Countries (LICs) and the needs of policy makers.

The model of the 2012 Workshops was a hybrid one, featuring presentations based on current research by both academics and influential international organizations like the IMF and the World Bank, discussions by the 'consumers' of this research – LICs policy makers –, and brainstorming sessions to discuss both the presentations and more general questions.

Contrary to the belief that data availability is a serious binding constraint to empirical research on LICs, it was reassuring to have high-quality and innovative empirical research presentations on short-term government spending multipliers, the effects of tax stimuli, and the transmission of monetary policy in developing countries, by Aart Kray (World Bank), Ethan Ilzetki (LSE), and Prachi Mishra (IMF), respectively.

Furthermore, the workshops highlighted significant efforts to incorporate the idiosyncrasies of developing countries into theoretical dynamic (stochastic) general equilibrium models. More specifically, Felipe Zanna (IMF) presented a model to capture the sustainability of debt generated by borrowing to finance public investment plans; Ehsan Choudhry (Carleton) and Hamza Malik (State Bank of Pakistan) presented a DSGE model that was built as a follow-up on the 2011 Workshops, which features inter-alia, budget constrained households, moderate independence of the central bank, and fiscal dominance; Gianluca Benigno (LSE) presented a model that reconciles high reserve accumulation by developing countries with fast growth and low net capital flows; Rafael Portillo (IMF) presented a model that captures the implications of structural transformation for inflation and monetary policy. Presentations are available on the IGC website.

Fiscal and monetary policy makers from Ghana, India, Pakistan, Bangladesh, Tanzania and Uganda actively participated, sharing their experiences and challenges in conducting policy in LICs. KP Krishnan (Economic Advisory Council to the Prime Minister of India) highlighted the increased importance of monetary and fiscal policy interaction in India, and particular challenges like monetary policy independence, the mixed views on international financial integration, etc. Nii Sowa (IGC and Member of the Monetary Policy Committee of the Bank of Ghana) discussed the evolution of monetary policy in Ghana and the importance of a target and a credible MPC process. Adam Mugume (Director of Research, Bank of Uganda) described the economic journey of the country in the past two decades and highlighted the

importance of communication, as one of the most effective instruments of monetary policy. Silvana Tenreyro (LSE) shared her experience as member of the Monetary Policy Committee of the Bank of Mauritius.

Some of the leitmotifs of the discussions during both days are: the plea of policy makers for more empirical macroeconomic research (currently there is an overabundance of micro, RCT-type, research in developing countries); the dominance of monetary policy in the intellectual debate; fiscal policy is under-researched; bringing models to the facts; a vast demand for research on institutional design.

Fiscal Policy in Developing Countries (2012) – summary

This report briefly summarizes some of the ideas conveyed by participants in the IGC Fiscal Policy Workshop, on November 2nd 2012. We abstract from covering specific presentations, although some of the findings that triggered extensive discussions are presented. Presentations and background papers can be found on the IGC website.

1. Fiscal Multipliers

The 2011 Workshop highlighted that good empirical research on the short-run effects of fiscal policy in developing countries is a priority. This year, this issue was addressed with studies that measure the short-run fiscal multipliers. Beleaguered by lack of good quality, high-frequency data, researchers' key challenge in such exercises is identifying variation in government spending that is uncorrelated with contemporaneous shocks to GDP. The solution might be to look at instruments like official external borrowing, a database compiled by the World Bank. Results suggest that the average, one year spending multiplier for developing countries is around 0.4. Participants exchanged ideas about the correct interpretation of this figure: while the multiplier for developing countries is relatively higher (even above one in some cases), 0.4 might not necessarily low per se, given that a) LICs are usually financially constrained, and b) aid in LICs rarely takes the form of official budget support, and aid might actually play a greater role than fiscal policy. Related to this last point, some participants reiterated that the 'effects of aid' is a very under-researched topic.

Some participants argued that focusing on the aggregate fiscal multiplier is a good first step in determining the effects of fiscal policy in developing countries; however, research on this topic ought to also study the distributional effects of policy, the drivers of the multiplier and asymmetries, particularly with respect to tax increase/decrease policies. Most of the LICs have a dual economy – a formal one and a subsistence one –, thus apart from overall increase in GDP, the effects of fiscal policy on the reduction of the subsistence sector might be a good indicator of success, as well. Furthermore, there were views that the counter-cyclicality of fiscal policy from an automatic stabilizers' perspective, rather than discretionary policy, remains under-researched. Lastly, it would be also helpful for policy to understand which sectors of the economy have the highest multiplier.

2. Debt Sustainability

This topic received fair attention by the participants, mainly due to its interconnectedness with fiscal rules, fiscal multipliers and issues of modelling debt sustainability. The definitions of 'optimal debt to GDP ratio' and a 'sustainable level of debt' were revisited from last year, suggesting that these issues still remain unsettled. Furthermore, participants felt that debt sustainability measures ought to be very country-specific, since the composition of debt – foreign vs. domestic – is very different for different countries, leading to different implications for sustainability. One of the messages of the presentations and discussion was

that government borrowing has repercussions for debt sustainability, even when the rate of return on projects is high. Since current borrowing can be financed by either future tax increases or more debt, if the tax code is too tight (not flexible enough), then future debt will eventually increase. Moreover, debt sustainability considerations are important when measuring fiscal multipliers, as a stimulus financed by debt might be perceived as future fiscal austerity. Participants also reiterated that more research was needed in understanding whether the Debt/GDP ratio was a good indicator to use as a fiscal rule.

3. Fiscal Rules and Fiscal Dominance

Fiscal rules were an important theme in the brainstorming session, mainly to follow-up on the issues raised in the 2011 workshops: why and when do they work, what they should be contingent on, etc. The general consensus was that fiscal rules are particularly hard to implement in LICs due to lack of fiscal discipline. On the other hand relying on market discipline is not a panacea, as governments often resort to financial repression to insure continued funding at low costs. Participants engaged in a lively debate about financial repression.

Some participants argued that the incentives of fiscal policy have changed as development has progressed. While in most LICs the enforcement of moderate fiscal discipline used to mainly come from the conditions and restrictions of the IMF (rather than any fiscal rule), in the process there has been some capacity building, too. Moreover, recent literature advocates more flexible fiscal rules to accommodate contingencies. The trade-off, however, less fiscal discipline incentives in otherwise undisciplined fiscal authorities. It was noted that the success of fiscal rules and the policy battle is contingent on a paradigm shift, a cultural change that economists are far from understanding.

The topic of fiscal dominance was discussed in more detail during the Monetary Policy Workshops (see summary for Day 2). Participants agreed that fiscal dominance is a serious constraint to the conduct of monetary policy and a burden on the private sector in developing economies.

4. Modelling Fiscal Policy in LICs

A general consensus was that there is high demand for research and models of institutional design and political economy, which would help to capture issues like government accountability, bureaucracy rigidities and the efficiency of government projects, and corruption. Participants argued that the current suite of models, i.e. general equilibrium with optimizing agents, etc., although incomplete, might help organize some discussions around fiscal policy issues and produce scenario analyses. However, bringing these models to the data still remains an unresolved problem mainly due to the scarcity of reliable macro data for LICs and the frequency of structural breaks. Some participants raised concerns about the confidence that we have on the calibrated parameters of these models, and

whether there can be a strategy to narrow down the confidence intervals. A more overarching task would be to build stylized facts about LICs, but the constraint, again, is data availability.

5. Communication of Research to Policy

Issues around communication of research to policy cross cut both the fiscal and monetary discussions. It was noted that one of the most important tasks for research is to actually find a way of signalling to policy makers the standard errors of our results, as variation in quality does not get communicated.

6. Fiscal Policy and Long-Run Growth

This topic did not receive particular attention in the discussions, however, some participants noted that there more research is needed in understanding whether fiscal consolidation matters for growth.

Monetary Policy in Developing Countries (2012) – summary

This report briefly summarizes some of the ideas conveyed by participants in the Monetary Policy Workshop, on November 3rd 2012. We abstract from covering specific presentations, although some of the findings that triggered extensive discussions are presented. Presentations and background papers can be found on the IGC website.

1. Monetary Policy Transmission Mechanism

This was one of the most heavily discussed themes of the 2012 Monetary Workshop. There was presented some evidence, based on empirical estimations, that the monetary transmission to inflation and output in developing countries was very weak. This research tested the a priori beliefs that the textbook monetary policy channels are not expected to fully work in developing economies due to the very restrictive assumptions underlying their functioning. The bottom line is that countries with better institutional environments, more developed financial structures and more competitive banking system are the most successful ones in influencing lending rates. However, other participants were strongly opposed to testing just the bank lending channel, as in many LICs the discount rate is not the main tool of monetary policy; many use monetary targets, reserve requirements, etc. A more comprehensive representation of the problem is to look at CB 'balance sheet' as an instrument.

Furthermore, a lot of LICs have undergone substantial structural transformation, which might invalidate a time-series estimation methodology. The arguments go even further: the a priori belief that the bank lending channel does not function might be questionable, since most of these countries are credit constrained. Some participants reiterated that monetary policy transmission should be studied more thoroughly for LICs, taking into account country specific characteristics such as the monetary policy regime.

The topic led to another issue that was raised at the Fiscal Workshop, too: a lack of quality control in the research that is communicated to policy makers might have serious consequences for policy, such as an inaction bias when they believe that monetary transmission is weak.

Lastly, participants voiced that an interesting and challenging intellectual undertaking is to understand how monetary policy transmission works in a dual economy (formal and subsistence).

2. LICs and Monetary Policy Targets

There were discussions on the consequences of blindly following an Inflation Targeting regime in LICs. There have been some countries that due to adherence to such policy, with flexible exchange rate regimes, have overlooked the decreasing competitiveness of their economies. An interesting question emerged: is flexible inflation targeting better than

exchange rate targeting in LICs? Having flexibility in IT means that central banks have some discretion in conducting policy; however, limited policy conducting experience and limited credibility might lead to a worse conduct of policy under discretion. Some discussants suggested that there is a need to look at other policy tools in face of potential lack of transmission (so only redistributive effects) and adverse effects of targeting only one variable, and constant supply shocks. One such tool could be fiscal policy (e.g. provide storage facilities for agricultural producers to hedge against food price shocks). However, others argued that this would have deep political economy implications.

On the topic of an inflation target vs. other monetary targets or no targets at all, participants reiterated that a) on a purely cognitive, psychological level it is easier to observe a target like inflation, thus it is easier to manage; b) it is better to have a target and a rule, despite drawbacks, than conduct policy ad hoc; c) money is inherently endogenous in policy, so the central bank cannot by definition control money. It was noted that a lot more research is needed on the composition of money.

3. Credibility

Some of the policy makers discussed that one of the most important achievements of Inflation Targeting and a Monetary Policy Committee process is building monetary policy credibility, which in turn, helps anchor inflation expectations. In this regard, there was a consensus that communication and monetary policy documents (transparency) are of paramount importance to achieving policy success. Others, however, argue that rather than transparency, accountability and communication, an important tool to build credibility is consistently meeting the target.

4. Fiscal Dominance

This phenomenon is something that is common among all LICs, possibly emerging economies and, more recently, developed economies, too. However, participants were under the impression that the intellectual/academic debate features monetary dominance. It was noted that more research was needed for fiscal policy, and, at the same time, the mismatch between human capacity in monetary institutions and fiscal institutions needs to be addressed. Some participants presented their findings, with a DSGE model, on the effects of monetary policy under fiscal dominance. They reiterated that even under an appropriate monetary policy rule, fiscal dominance would lead to high and volatile inflation and cause large losses. Furthermore, macroeconomic performance can be considerably improved if fiscal policy takes the responsibility to stabilize debt.

5. Structural Transformation and Monetary Policy Targets

There was a discussion on the effects of structural transformation in developing countries. Evidence suggests that nearly 50% of inflation volatility in the median African country can be attributed to the change in relative food prices. Participants noted that the larger the food

share in inflation, the more costly it is to target headline inflation. Thus, a more optimal target for LICs could be the volatility of the relative price of food, given that there is a large share of subsistence in food consumption, limited financial participation, costly internal transport and real wage rigidities in the non-food sector.

6. Modelling Monetary and Fiscal Policy – Empirical support and DSGEs

It was reassuring to see that the 2011 Workshops on Fiscal and Monetary Policy inspired some work on DSGE models with developing economies' features, such as financial frictions, liquidity constrained households, a 2-household setup (high- and low-income) to explore distributional effects, fiscal dominance and endogenous credibility. However there were two main issues that were raised by participants: a) in all models presented the government was not an optimizing agent; and b) it seems like theoretical modellers are being more proactive than empirical economists – the calibration of these models is not broadly based on empirics. There were some views that optimization does not actually capture the facts, e.g. fiscal dominance is not an outcome of optimization. Others added that it might also be a communication problem – it is hard to explain to policy makers what solving the Ramsey problem means. There was a consensus that modelling and gathering stylized facts should be parallel to each other; however, the efforts are currently not balanced.

7. Macro-prudential policy

This topic was not substantially covered, but it was noted that developed countries could actually learn from developing ones, since the latter have always conducted macro-prudential policy by their monetary institutions. The financial sector is one of the fastest growing ones in LICs, thus close supervision policy helps with conducting monetary policy.