Macroeconomic Management in a Constrained Fiscal Environment

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What do we mean by a “constrained fiscal environment”? 

- Fiscal deficits and/or public debt ratios are larger than optimal from the standpoint of macroeconomic management and fiscal sustainability, but not yet large enough to cause a fiscal crisis.

- The main reasons are narrow tax bases and overextended government structures, which means that government agencies are often chronically underfunded.

- In constrained fiscal environments, budget outcomes are often more uncertain (e.g. deficits may be larger than budgeted), because of revenue shortfalls or over-spending.
Trends in fiscal outcomes in SSA since the global economic crisis

- As shown in the next two slides, fiscal positions in SSA, on average, have deteriorated since the onset of the global crisis in 2008.

- Overall fiscal balances were lower in 2013 than in 2007 by 7.4 and 5.7 percent of GDP in the oil exporters and the middle income countries (MICs) respectively, and by 2 percent of GDP in low income countries (LICs).

- Public debt ratios are much higher in MICs, less so in oil exporters and LICs.

- These data are averages for groups of SSA economies; individual countries have more worrying fiscal positions.

- There were 8 countries (excluding fragile states) with fiscal deficits larger than 6 percent of GDP and 12 countries with public debt exceeding 40 percent of GDP in 2013.

- In conclusion, approximately one quarter to one third of the non fragile economies of SSA appear to be fiscally constrained, with very little fiscal space available to either accommodate new fiscal priorities or to pursue countercyclical fiscal policy.
Overall Fiscal Balance (percent of GDP): Oil Exporters, Middle Income Countries and Low Income Countries of SSA; 2004-2013

Low income countries exclude the fragile states
Source; IMF Regional Economic Outlook, Appendix table SA8
Government Debt (percent of GDP): Oil Exporters, Middle Income Countries and Low Income Countries of SSA; 2004-2013

Low income countries exclude the fragile states
Source: IMF Regional Economic Outlook, Appendix table SA12
What are the implications of the constrained fiscal environment for macroeconomic management?

There are five separate ways in which a constrained fiscal environment affects macroeconomic management:

1. Lack of fiscal space to use fiscal policy itself as a tool of countercyclical macroeconomic stabilisation;

2. Monetary policy may have to be tighter to offset looser fiscal policy;

3. Uncertainty over fiscal outcomes makes inflation forecasting more difficult which may force central banks to adopt a more cautious monetary policy;

4. If fiscal deficits are financed with borrowing from the central bank, monetary policy will be undermined;

5. A more expansionary fiscal stance appreciates the real exchange rate.
Countercyclical fiscal policy

In the wake of the global financial crisis, which reduced aggregate demand in SSA (through lower net exports and investment flows), several governments in SSA expanded the fiscal stance as a tool of countercyclical stabilisation, which helped to mitigate the slowdown in real output growth.

This was possible because these governments had created fiscal space, through very prudent fiscal policies in the pre-crisis years.

The deterioration of fiscal balances and public debt ratios in some SSA economies since 2007 means that there is now much less fiscal space; hence the scope for using fiscal policy as a countercyclical tool to boost aggregate demand, should that be necessary, is much reduced.
Monetary policy

Unless there is unused capacity in the economy (a negative output gap), a more expansionary fiscal stance will force the central bank to raise its policy interest rate, to avoid excessive growth in aggregate demand.

This is shown on the next slide, in real output ($Y$) and real interest rate ($r$) space, where $¥$ is potential output.

The fiscal expansion pushes out the aggregate demand (AD) schedule. At the original interest rate, $r^1$, the economy will overheat as output is pushed above potential.

To prevent overheating and a rise in inflation, the central bank raises the interest rate to $r^2$.

The burden of adjustment to the fiscal expansion is borne by lower private sector spending, brought about by a higher real interest rate.
Monetary policy implications of fiscal expansion
Uncertainty and monetary policy

• A constrained fiscal environment makes fiscal outcomes more uncertain; fiscal deficits may be larger than planned.

• Monetary policy is forward looking and is guided by forecasts (12-18 months ahead). Fiscal uncertainty makes inflation forecasts more uncertain.

• If inflation forecasts are more uncertain, the central bank will be more cautious in setting monetary policy. It will not want to run the risk of inflation rising above target (which would damage its credibility) because the fiscal outturn is more expansionary than expected and hence, ex post, the policy interest rate was too low.
Financing of fiscal deficits

• If fiscal deficits are too large to be fully funded from the market, government may resort to the central bank;

• Central bank financing of the budget creates reserve (base) money or involves loss of foreign exchange reserves;

• To maintain a constant monetary policy stance, any creation of reserve money must sterilised (mopped up) by the central bank by issuing securities to the market;

• If the central bank lacks sufficient securities to sterilise money creation, the implementation of monetary policy will be undermined.
Appreciation of the real exchange rate

A fiscal expansion raises demand for non traded goods (unless all of it is spent on imports).

Increased demand for non traded goods appreciates the real exchange rate, which will worsen the trade balance.

A lower trade balance dampens aggregate demand, thereby partly offsetting the boost to AD from the fiscal expansion.

This is illustrated in the next slide, which adds a balance of payments (BP) schedule to the figure in slide 9.

As in slide 9, the fiscal expansion pushes the AD schedule rightwards (to AD\(^2\)) but it also shifts the BP schedule up to BP\(^2\) (because the real appreciation requires a higher real interest rate to maintain external balance).

However, the appreciation of the real exchange rate dampens the rightward shift in the AD schedule, bringing it back to AD\(^3\), which allows the central bank to set a lower real interest rate (at r\(^3\)) to maintain domestic balance than was the case in slide 9, which did not take account of exchange rate effects.

When the real exchange rate appreciates, the burden of adjustment to the fiscal expansion is borne partly by lower private sector spending, brought about by a higher real interest rate, and partly by lower traded goods production, brought about by real exchange rate appreciation.
The balance of payments implications of fiscal expansion
Conclusions

• Since 2007, a deterioration in fiscal balances and public debt ratios in some SSA economies has reduced fiscal space.

• This has constrained the scope for countercyclical fiscal policy.

• A more expansionary fiscal stance means that, ceteris paribus, monetary policy is likely to be tighter.

• Fiscal outcomes are more uncertain, which also means that monetary policy will be more cautious.

• The dangers that fiscal deficits will be funded by central banks, undermining monetary policy, has increased.

• Real exchange rates will be more appreciated, damaging incentives for traded goods production.