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Restarting and Sustaining Growth and Development in Africa: The Role of Macroeconomic Management

Accountable and suitably restrained public organizations are essential for sound macroeconomic management. In turn, sound macroeconomic management is an essential foundation for enhancing productivity. This policy brief considers how improved macroeconomic management contributes to restarting and sustaining growth and development in Africa.

Dealing with these problems requires the reorientation of macroeconomic management. That effort typically involves four interrelated tasks. The first is to achieve balance between domestic demand and potential output in ways that lead to the highest utilization of resources consistent with price stability. The second is to maintain an exchange rate that promotes rapid export growth and a sustainable current account. The third task is to develop and maintain well-ordered financial arrangements that balance aggregate saving and investment and provide an efficient, market-based allocation of available capital. The fourth is to ensure that public and private sector borrowing remains within prudent limits.

Exchange Rates: With appropriate macroeconomic policies and strong political support, a fixed exchange rate may contribute to economic stability and improve the climate for investment. But, fixed exchange rates can become overvalued and the effort to maintain them can create instability. Moreover, as Asian experience has shown that success in maintaining a fixed exchange rate may attract destabilizing capital flows.

However, it does not follow that floating exchange rates provide a painless solution to balance of payments problems. In principle, floating rates require minimal intervention since markets move the exchange rate to keep the external accounts in balance. That does not, of course, allow governments to conduct their monetary and fiscal policies without concern for trade and external payments. Exchange markets respond quickly to actual or threatened inflation.

The long lags between exchange rate movements and the resulting changes in imports and exports exacerbate exchange rate volatility. Moreover, exchange rates are also driven by variations in foreign aid and remittances, as well as by

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interest rates and expectations about changes in capital markets. They also respond to expectations of policy change and fears of political instability.

These considerations make movements of nominal and real exchange rates difficult to explain and to forecast. In time, exchange rates do respond to changes in relative prices and they do respond to changes in the factors underlying the supply of and demand for commodities. However, there may be considerable unexplained and unwanted variation in exchange rates and trade flows over the short-term. These will be minimized if other aspects of macroeconomic management contribute to stability.

Fiscal Policy: Fiscal policy is too cumbersome for short run demand management. Most of the time governments must rely on monetary policy for demand management while ensuring that fiscal policy does not add to the difficulties. But fiscal policy has a positive role to play in response to shocks. When the terms of trade deteriorate or when harvests fail, as often happens in Africa, the decline in real national income must be matched by some combination of reduced domestic absorption, increased borrowing, or additional aid. In promoting adjustment, policy makers need to focus more heavily on reducing budget expenditures than borrowing or aid. Failure to do that in the 1970s created the debt and balance of payments problems that still burden African countries.

Over the long term, fiscal policy contributes to economic growth through the efficient use of resources made available through taxation, foreign aid, and foreign investment. Capital is scarce in Africa and should not be wasted. In their budget management, governments should run a current surplus. Capital expenditures should only exceed that surplus when it can be shown that the expenditures have a higher social return than private alternatives. With levels of debt they cannot service, African governments have no justification borrowing to finance deficit spending. This situation holds even though initiatives now exist to provide massive debt relief to the poorest countries. Indeed, these initiatives will fail unless African governments take steps to swing their budgets and balance of payments into surplus.

Tax policy should be designed to raise revenue with as few distortions as practicable. The heavy reliance on trade taxes in Africa creates serious distortions. Government expenditures are typically overburdened by payments on wages, arrears, and internal debt service. One goal of reducing debt should be to release resources to ensure adequate funds for operations and maintenance thereby raising the efficiency of the physical capital that governments have at their disposal.

Monetary Policy: Monetary management becomes very difficult if the central bank is expected to finance government deficits. The availability of easy access to central bank credit undermines budget discipline and often requires the central bank either to give up controlling inflation, or to use high interest rates to crowd out private borrowers. Similarly, borrowing by state-owned enterprises has seriously weakened banking systems across Africa. It has created moral hazard, encouraged imprudent lending, and generated large losses for banks and governments.

In Africa, as elsewhere, the central objective of monetary policy is to achieve the fullest utilization of resources consistent with an acceptable inflation target. Even the central banks that have publicized their inflation targets acknowledge the importance of output and employment considerations. They also recognize the need for monetary ease when demand weakens. However, the use of inflation targets is meant to give notice that central banks will not allow supply shocks to set off wage-price spirals. It also affirms that they will not accommodate budget deficits.

Unlike fiscal policy, monetary policy can be adjusted continually without lengthy decision or implementation lags. Unfortunately, the lags between monetary actions and their effects on economic activity are long and variable. This complicates monetary management due to the need to forecast economic conditions many months ahead.

Central banks have one main policy instrument. They can control the supply of reserve money, usually by means of treasury bill auctions or open market operations. That allows them to control either market interest rates on short-term securities or the money supply. Currently most central banks use the indirect control of short-term interest rates as their primary policy tool. They raise interest rates when they believe that too rapid demand growth will generate inflation and reduce them when they fear slow output growth.

Because of the difficulty of predicting demand movements and the response of prices to these movements, together with our imprecise knowledge of the effects of interest rates, central banks cannot prevent fluctuations in output, employment, or prices. But, in the absence of major shocks a gradualist monetary policy together with a sound fiscal policy can be expected to keep the economy on a stable path.

While institutional weaknesses often make routine monetary operations difficult in Africa, the core central banking problems arise from supply shocks, balance of payments deficits, and fiscal imbalances. An early response to shocks is required because inflation caused by excess demand will continue as long as price increases are matched by increases in nominal demand. Moreover, if inflation is allowed to persist, expectations of continued inflation become established. Subsequent price rises make stabilization more difficult to achieve.

Financial System: An important concern for all African central banks is the financial system. After years of mismanagement, the banking systems of many African countries are being restored to solvency, supervision is improving, and central banks have moved toward indirect control of the supply of money and credit. Even with these changes African banking systems will still directly serve only a small segment of the economy. When working well, they provide a safe haven for those who wish to save in financial form rather than in real capital.

Financial stability is essential for efficient intermediation and financial deepening. African financial markets remain shallow with few opportunities for the expansion of specialized organizations such as merchant banks and finance houses. African governments have complicated the situation by attempting to promote financial development through various "supply-leading" financial initiatives. These have not worked since financial development largely depends on the expansion of markets and the reduction of intermediation costs. These, in turn, require economic liberalization and mechanisms that more closely integrate African economies with the global financial system.

Capital Flows: A major objective of restoring financial stability is to reverse the trends in capital flight and currency substitution. African countries now have long experience with capital outflows. We know from IMF and other data that Africans residents hold large deposits in foreign banks. Those offshore holdings represent African savings that might have been productively invested at home. Any African country that can make investment conditions attractive enough to induce its citizens to bring home their wealth will raise investment and accelerate growth. Indeed, this is the first step in attracting foreign direct investment.

To end capital outflows and encourage the return of flight capital, African governments have to rebuild confidence in the future of their economies.

This requires, among other things, price stability, a consistent approach to exchange rate management, and monetary and fiscal policies that help countries bring their external debt under control.

Debt Management: There have now been many attempts, mostly by the donor community, to resolve Africa's debt problem. Initiatives include selective debt write-downs, write-offs, and concessionary refinancing. The modifications to the Highly Indebted Poor Countries (HIPC) initiative in light of the Cologne accord of the G-8 offer the possibility that many African countries will ultimately achieve deep debt reductions. Yet, for African countries, the problem is not just one of getting out of debt. The conditions have to be created to keep them out of debt.

In principle, net aid flows have been more than adequate to cover the debt service payments for most African countries. There are frequent delays in those flows due to donor disbursement procedures or the problems of meeting conditions attached to aid. But external debt is only part of the problem. Many African countries have large stocks of domestic debt due to past deficit financing, public sector losses, and loan guarantees that have been called.

These debts are so large they narrow the options for macroeconomic managers. Debt is no longer a "cushion" for current operations. The shortage of foreign exchange reserves places greater stress on the need to adjust. African governments have to be far more proactive in addressing their debt problems. The "aid exit" strategy (explained in another policy brief) is also a "debt exit" strategy.

Overview: None of the above activities can be examined independently. Monetary and fiscal policies and exchange rate and debt management require coordination. Interpretations of what is involved vary. In the franc zone, the regional central banks dominate monetary policy and have a role in determining fiscal limits for member countries. The exchange rate is fixed and non-negotiable. In other African countries, governments determine fiscal policy, strongly influence monetary policy and, with few exceptions, manipulate their exchange rates. Notwithstanding these different approaches, if macroeconomic management is indeed to become the foundation for sustained growth and development, policy makers will have to heed the basic principles and limits noted above.

This policy brief is based on EAGER Discussion Paper Number 52, *Restarting and Sustaining Growth and Development in Africa: The Macroeconomic Dimension*, 2001, by James S. Duesenberry [jduesenberry@harvard.edu] and Malcolm F. McPherson [Malcolm_McPherson@harvard.edu], Belfer Center for Science & International Affairs, John F. Kennedy School of Government, Harvard University.

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