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ECA POLICY BRIEF

Macroeconomic policy for structural transformation of African economies

Macroeconomic policy as an engine for transformation

African economies are slowly transforming but at a low pace compared to their potential and development aspirations. It is now recognized that one of the contributing factors has been the ineffectiveness of past macroeconomic frameworks in undertaking the type of public investment required to promote private investment, to develop a productive public-private interface, and to implement countercyclical macroeconomic policies.

The development planning period of post-independence (1960–1980) subscribed to the large role of the State in the development process. However, it failed to adequately engage the private sector and build the capacity required for structural transformation. As the development model achieved limited success and macroeconomic imbalances developed over time, the perceived government failure was dealt with through structural adjustment programmes led by the international financial institutions. During the period 1980–2000, extensive liberalization, deregulation and privatization were introduced, and the role of the Government was limited to maintaining macroeconomic stability. The fiscal retrenchment left little room for public investment and delivery of public goods, and little support for building up the weak private sector. Additionally, it was procyclical in nature, causing commodity dependent economies to adopt austerity measures at a time of negative exogenous shocks to commodity export revenue.

The resulting underinvestment and capacity gaps have hindered progress towards value addition and inclusive development. It has been recognized that African countries need developmental States with macroeconomic frameworks firmly anchored in their long-term development strategies, in order to promote structural transformation and inclusive growth. It is for this reason that the Economic Commission for Africa conducted a study on “Macroeconomic policy and structural transformation of African economies”. The key messages of the study are presented in this policy brief.

Building productive assets and institutional transformation

Macroeconomic frameworks are essential for countries to balance their stability and development objectives. While in the long run the two aims can be complementary, in the short run a clear trade-off exists between them. Macroeconomic policies have so far been mainly judged against their stability objectives, placing emphasis on the short term. In the context of the long-term view – the considerable developmental needs of African countries – such a narrow focus is not adequate. Figure 1 outlines how macroeconomic policies sit as a part of the overall long-term development agenda, and contribute to the structural transformation process.

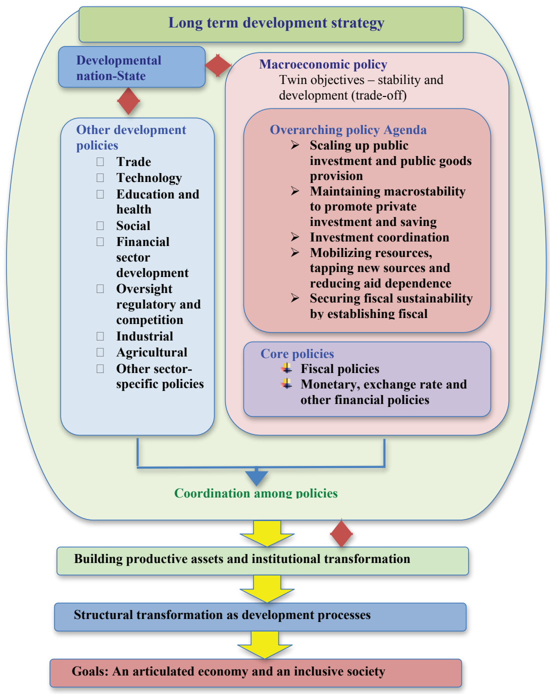
A consistent framework for macroeconomic policies contributes to the institutionalization of the national development strategy, which is interrelated with the quality of policymaking, regulatory frameworks and their implementation. The institutional configuration contributes to high quality policy development, enforceable regulatory mechanisms and effective implementation. At the same time, effective policies feed into the evolution of institutions, further strengthening the institutional set-up and the legitimacy of the State.

In this context, macroeconomic policies seek to accomplish several aims. The scaling up for public investment and public goods provision, in a coordinated way, contributes to the creation of productive assets and lays the foundation for sustainable growth and fiscal legitimacy (e.g. in the form of enhanced tax compliance). This facilitates the mobilization of resources and reduction of aid dependence over time.

Stability should also be incorporated into the development planning framework, rather than be seen as a stand-alone objective. In fact, macroeconomic stability, as a promoter of private and public investment, is a key element for the creation of productive assets and therefore structural transformation. Accordingly, in the long term, there is no conflict between the two aims. Shorter term action plans allow the stability aim to be dealt with in a consistent manner, while bringing flexibility into the development planning framework.

Since development is a concept wider than growth, macroeconomic policy alone is not enough. Instead, it needs to be accompanied by and coordinated with complementary sectoral and other policies, such as trade, technology, education and health. The coordination is facilitated by the overarching national development strategy.

Figure 1: Building blocks and channels for structural transformation



Sustainable fiscal policy based on legitimacy

Particularly during the period of structural adjustment programmes, monetary policy had taken precedence over fiscal policy in search of stability, not recognizing the key role of fiscal policy in creating a productive public-private interface. The dual roles of fiscal policy – providing public goods and mobilizing resources – make it one of the critical conduits for advancing structural transformation, especially in the current international architecture of development finance. To fully operationalize this channel, it is important to deploy an integrated approach to the two sides of fiscal balance – revenue and expenditure – rather than focus on reducing the net deficit only.

The East Asian development experience has shown that Governments can advance structural transformation through conscious inclusive spending. By targeting the creation of productive assets, which includes both primary assets such as land, and secondary assets such as infrastructure and institutions, the benefits of growth can be shared among all sectors of the population and be built on for sustainable development. A key element of such efforts is the effective delivery of public services. In East Asia, measures such as free and universal primary education, promotion of small enterprises and development of rural infrastructure, supported a shared growth experience and upgrading of linkages to the world economy.

Quality public services also enhance the legitimacy of the Government. The perceived legitimacy is crucial for addressing the revenue side of fiscal policy. African countries are characterized by an unbalanced tax base, dominated by taxes on trade and natural resources. To widen the tax base, previously underutilized forms of taxes need to be considered, such as corporate and property tax.

The formalization of the large informal sector, common in many developing countries, can be a source of sustainable structural transformation. The goal of this engagement is the provision of public services and goods for the sector. In the first instance, it is unrealistic to aim for revenue generation through taxation of the informal sector. However, creating a productive relationship with the entrepreneurs can lay the foundation for a future, wider tax base.

Another source of revenue is natural resources, which must be better utilized. The engagement of African countries with transnational corporations in the sector has been characterized by a “race to the bottom”, with Governments competing on the provision of tax reductions and exemptions, often in a highly non-transparent manner. Instead, countries should move towards a “race to the top”, by improving the general business environment. The issue of illicit financial flows, which is often related to natural resource rents, should also be tackled.

The net fiscal balance is an indicator of responsible management of public finances and should be carefully managed. At the same time, the underlying fiscal philosophy must be countercyclical. The gains from commodity price booms should be spread across time through, for example, sovereign stabilization funds. Such time phasing addresses the limited capacity of the economy to absorb additional resources in the period of boom, and provides a buffer in case of negative shocks.

Monetary policy for stability and development

The recent macroeconomic discussions on monetary policy are focused on the debate on inflation targeting. The perceived advantage of the inflation targeting regime is its promise of simplicity and ease in communicating to the public. Rule-based management of macroeconomic stability also contributes towards building central bank credibility. A number of countries in Africa have already adopted an inflation targeting monetary regime. However, it is necessary to consider whether inflation targeting is a suitable policy approach for Africa for several reasons, including the cost-push nature of inflation, and the lack of deep financial markets in many African countries.

Monetary policy needs to acknowledge the dual targets of stability and development. By committing to a strict policy stance on low inflation, African countries may find themselves bearing too high a cost in terms of developmental outcomes. Inflation targeting may, for example, negatively affect the trajectory of development through the real exchange rate and the highly volatile, procyclical capital flows – that countries dependent on natural resources are subject to.

An additional concern is that exchange rate policy in small developing countries, which includes many African countries, are complicated by the fact that exchange rate policy affects external and internal balances through stabilization and expenditure switching. Exchange rate policy not only affects the net external trade balance through the competitiveness of tradable goods, but also internal resource allocation between tradables and non-tradables. Accordingly, to maintain the balance between stability and development, a degree of flexibility is required in exchange rate policy.

Fixed exchange rate regimes, while promoting stability, may entail dramatic adjustment measures in case of external shocks, at the cost of growth and development. On the other hand, a real target approach aiming for competitiveness may not adequately deal with stability concerns. An intermediate regime, such as target zone or crawling band, may be considered. It has also been suggested that undervalued currency, through the promotion of tradable goods, may be used as a developmental policy tool for structural transformation. But this depends on external factors beyond national policies (e.g. inflation rate movements in major advanced economies and trading partners of Africa). As a consequence of the global financial crisis, different forms of capital control, interest rate regimes and stimulus packages have also emerged.

Financial stability and development of financial markets

In the light of the global financial crisis, it has become clear that financial stability needs to be considered as a separate element of macroeconomic stability, and needs to be dealt with separately through financial policies to prevent systematic risk in financial systems from developing uncontrollably.

The development of financial markets is also crucial for the effective use of innovative financial instruments for development and structural transformation. These instruments seek to better tap into non-concessional sources of financing to complement the declining flows of official development assistance. Sovereign bonds have been issued by some African countries, such as Ghana, Ethiopia and South Africa. The success of raising funds through sovereign bonds has encouraged other African countries to take steps towards launching their own to raise funds for economic infrastructure.

However, the potential risk of such financing has to be recognized. The terms of sovereign bonds are not as favourable as the concessional loans available for developing countries. Foreign investors will also seek to hedge and shed risk to achieve maximum risk-adjusted returns, adding to the volatility of private investment. Potentially less risky alternatives are sovereign stabilization funds and diaspora bonds, which have been introduced by some African countries. Some countries have also been successful in leveraging on domestic bond markets.

Policy recommendations

- To achieve the aims of the overarching policy agenda, fiscal, monetary, exchange rate and other macroeconomic policies should be carefully developed and coordinated; and in order to do this, there is a need to:

- Establish fiscal legitimacy and broaden the tax base by providing high-quality public goods and services.

- Staunch illicit cross-border financial flows and turn natural-resource wealth into productive assets through inclusive fiscal spending.

- Sustainably manage public finance and sovereign debt through countercyclical macroeconomic management and development of accountable and transparent institutions for public resource management.

- Reappraise the contractionary bias in the conventional monetary policy stance in order to strike a better balance between the twin objectives of stability and development.

- Conduct monetary policy, following a careful evaluation of the sources of inflationary pressures, including those emanating from supply shocks in agriculture.

- Conduct domestic monetary policy in conjunction with an appropriate exchange-rate regime, and manage cross-border capital flows in a country- and region-specific context.

- Adopt regulations, including measures aimed at taming market excess, on international capital flows and domestic financial conditions.

- Mobilize resources in parallel with efforts at deepening domestic financial markets, and strengthen the capacity of financial institutions so that they can play a fuller role in resource mobilization, financial inclusion and financial intermediation.

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