



## Stabilization policies

Arthur Silve

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# Stabilization policies

## fiscal policy and nominal adjustment tools

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2013



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# The 3 classic functions of the state

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## 3 justifications for economic policy

- stabilization (sustainability)
- redistribution (as such)
- regulation



# Fiscal policy objectives

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## Fiscal policy affects all economic policies

- public good financing
- stabilization policy
- financial crisis
- sovereign defaults
- systemic risk and “too-big-to-fail”
- hyperinflation
- resources management



# Fiscal stabilization

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- Production  $\implies$  demand
- Demand  $\implies$  new markets for supply



# The role of a fiscal stimulus

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In equilibrium, an increase of public expenditures

- crowds-out private demand
  - increases the costs of funds
  - raises prices

- crowds-out local production

In the short run

- supply elasticity and price rigidity  $\implies$ 
  - demand shocks affect directly the productive sector
  - with potentially devastating consequences



# Monetary policy: fixing anticipations

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Economic and financial crises are often crises of confidence

- in the value of currency
- in the value of savings

Fixing anticipations is crucial for the economic stability

- to facilitate transactions and contracts
- to encourage savings and investment
- to avoid financial crises, usually long and costly

AND an exchange rate / monetary policy can also sustain LT growth

- indirectly by creating confidence
- and directly by sustaining the export sector



# Monetary policy objectives

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The monetary policy also affects several policies

- stabilization policy
- financial crises
- it also has consequences in terms of inflation and redistribution



# Monetary stabilization

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## In the LT

- neutrality of money
- economy constrained by supply
- quantitative theory of money:  $MV=PT$

## But in the ST

- nominal rigidity (of prices)
- interest rates balance the supply and demand of money
- $M^d(P, Y, i) = P.L(Y, i)$



# Role of a monetary easing

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## When the Central Bank decides to lower its prime rate:

- disincentive to save, consumption and investment boost
- asset prices increase
  - wealth effect (households)
  - increased investment of firms whose capital is revalued
- stimulates credit supply
- depreciation of the currency



# The policy-mix

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Fiscal and monetary policies share common objectives

- both may be used to smooth ST demand

...and conflicting objectives

- different time horizons

- and a conflict of interest (which prevents the implementation of a real policy-mix)

...which generally lead to institutionalize the independence of the two policies

- a direct public policy recommendation (for once)
- that is not easy to implement



# Combined effects of policies

Efficiency of a fiscal stimulus

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	high mobility	low mobility
flexible	hardly efficient	efficient
fix	efficient	hardly efficient



# Example of policy-mix: overheating

Positive output gap

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In general, an excess of liquidity

- domestic origin: strong credit growth
- foreign origin: important capital inflows

The potential consequences of an excessive liquidity

- inflation (cf. next section)
- asset prices bubbles (cf. next section)
- credit quality deterioration (financial system)
- currency mismatches (capital account)



# Overheating: Vietnam 2007

Accounts of the BoP

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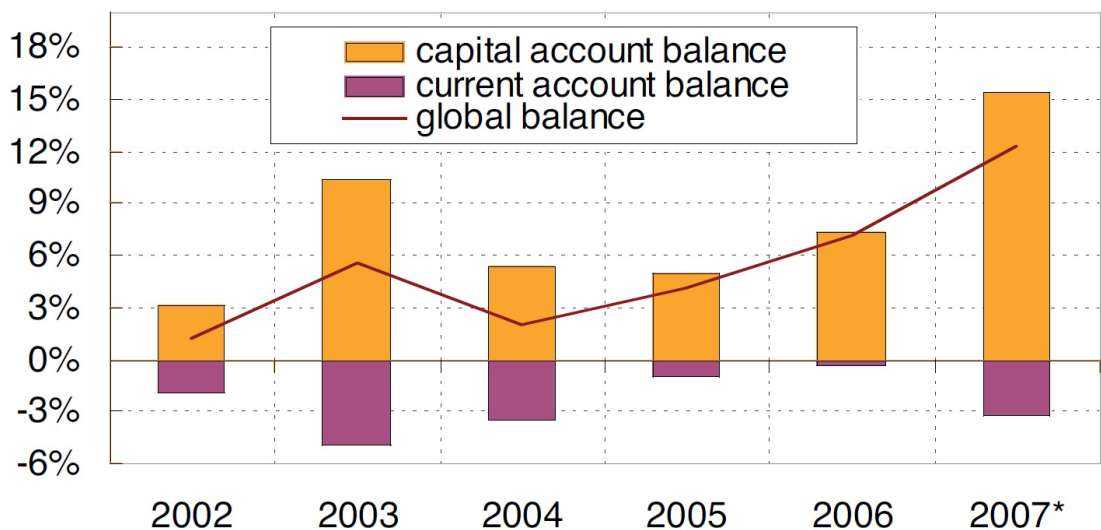
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Source: AS. Y:% of GDP

# Overheating: Vietnam 2007

Credit to the economy

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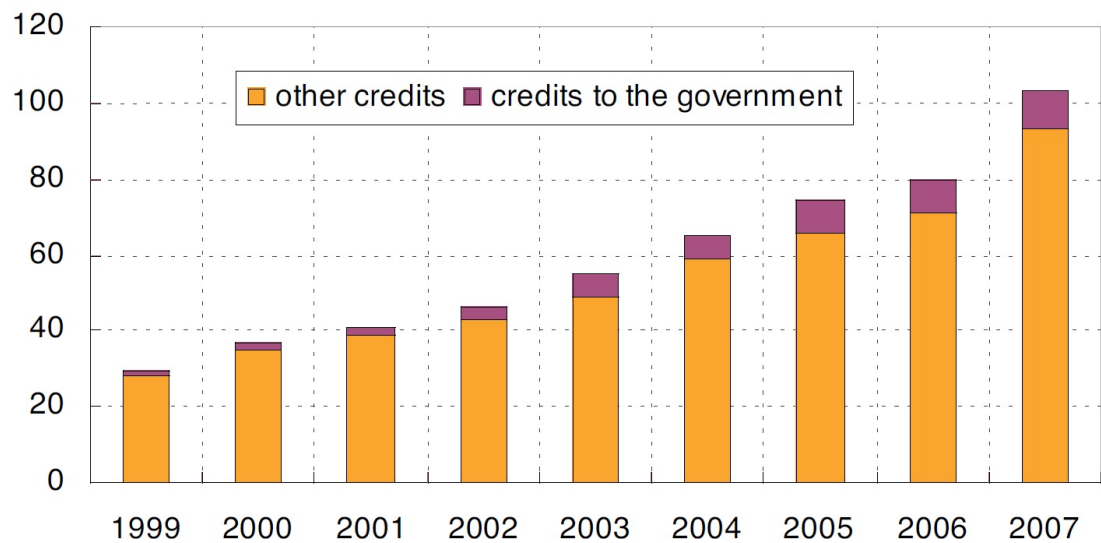
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Source: AS. y: % of GDP

# Overheating: Vietnam 2007

VNI / stock price index

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Source: AS



# Overheating: Vietnam 2007

## prices and food prices

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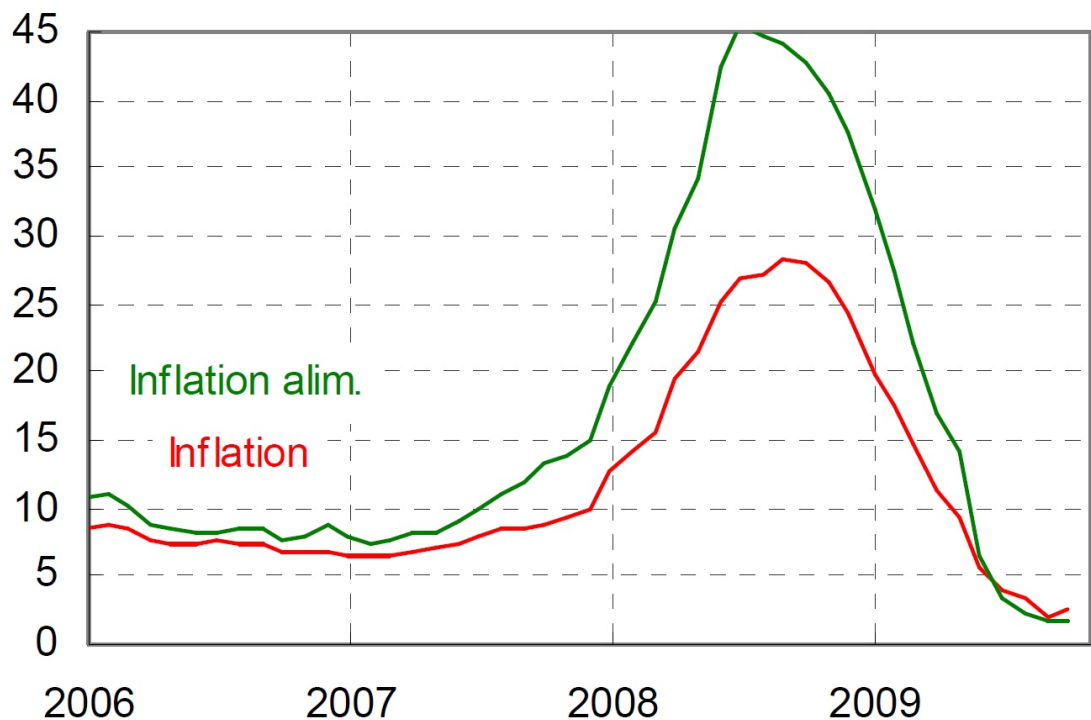
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Source: AS. y: % of yoy growth

# Diagnose the overheating

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## Indicators

- capital inflows
- fast credit growth
- inflation
- volatility of asset and good prices

## Some policy alternatives

- inflation: countercyclical monetary policy + credit and capital flows regulation
- asset price bubbles: difficult to diagnose
- NPL and mismatches: prudential regulation of banks and firms



# fiscal redistribution

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- health insurance and unemployment benefit
- retirement and pensions
- redistribution according to income criteria
  - macroeconomic point of view: from middle-classes towards poorer populations
    - progressive taxation and public good provision
    - subsidies on goods of first or second necessity
  - political economy point of view: appropriation by the elites



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# State budget

## Tables from Senegal: article IV

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	2009	2010	2011		2012		2013	2014	2015	2016	2017
			EBS/ 11/176	Actual	EBS/ 11/176	Prog.			Proj.		
(Percent of GDP)											
Total revenue and grants	21.7	22.0	22.6	22.4	23.4	23.4	23.3	23.4	23.4	23.1	23.1
Revenue	18.6	19.4	20.2	20.2	21.1	20.7	20.7	20.7	20.8	20.5	20.6
Tax revenue	18.0	18.8	19.0	18.9	20.0	19.5	19.2	19.3	19.4	19.5	19.6
Income tax	4.8	5.3	5.2	5.1	5.2	5.2	4.9	5.0	5.1	5.2	5.2
Taxes on goods and services	10.2	10.9	10.6	10.7	11.6	11.5	10.7	10.9	11.0	11.1	11.1
Taxes on petroleum products	3.0	2.6	3.2	3.1	3.2	2.8	3.6	3.4	3.3	3.3	3.3
Nontax revenue	0.6	0.7	0.7	0.7	0.7	0.7	1.0	1.0	1.0	1.0	1.0
FSE			0.6	0.6	0.5	0.5	0.5	0.4	0.4	0.0	0.0
Grants	3.0	2.5	2.4	2.2	2.3	2.7	2.6	2.6	2.6	2.6	2.5
Total expenditure and net lending <sup>1</sup>	26.7	27.1	28.8	29.0	28.9	29.8	28.0	27.6	27.3	26.9	26.8
Current expenditure	16.5	15.6	17.4	18.1	16.3	17.3	16.4	16.0	15.2	15.0	15.0
Wages and salaries	6.0	6.2	6.1	6.3	6.0	6.2	6.0	6.0	6.0	6.0	6.0
Interest payments	0.8	0.9	1.2	1.5	1.5	1.5	1.6	1.6	1.5	1.5	1.5
Other current expenditure	9.7	8.5	10.1	10.3	8.8	9.5	8.8	8.4	7.7	7.5	7.5
Of which: goods and services	4.8	4.6	5.1	5.2	5.2	5.1	4.9	4.8	4.7	4.7	4.7
Of which: transfers and subsidies	4.7	3.8	4.8	4.9	3.4	4.3	3.7	3.4	2.8	2.7	2.7
Of which: energy and food subsidies	1.0	0.0	2.0	2.0	0.6	1.6	1.0	0.7	0.1	0.0	0.0
HIPC and MDRI current spending	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Capital expenditure <sup>2</sup>	10.1	11.6	10.9	10.5	12.7	12.6	11.6	11.7	12.1	11.9	11.8
Domestically and nonconcessionally financed	6.1	6.9	6.8	7.0	7.6	7.0	6.5	6.6	7.2	7.1	7.2
Externally (concessionally) financed	3.9	4.7	4.1	3.6	5.2	5.6	5.1	5.1	5.0	4.8	4.6
Net lending	0.1	0.0	0.5	0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Selected public sector entities balance <sup>3</sup>	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary fiscal balance	-4.1	-4.2	-5.1	-5.2	-4.1	-4.9	-3.2	-2.7	-2.4	-2.3	-2.1
Overall fiscal balance											
Payment order basis, excluding grants	-7.9	-7.8	-8.6	-8.9	-7.8	-9.1	-7.3	-6.9	-6.5	-6.4	-6.2
Payment order basis, including grants	-4.8	-5.2	-6.2	-6.7	-5.6	-6.4	-4.7	-4.3	-3.9	-3.8	-3.7
Financing	4.8	5.2	6.2	6.7	5.6	6.4	4.7	4.3	3.9	3.8	3.7
External financing	3.7	2.7	4.7	6.2	3.6	5.4	5.1	4.4	4.2	4.1	4.0
Domestic financing	2.6	2.7	1.6	0.2	2.0	1.4	-0.4	-0.1	-0.3	-0.3	-0.3
Settlement of payment delays	-1.6	-0.2	-0.1	0.3	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

# Revenues, financing, monetization

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Expenditures can be insured through several ways

- fiscal and non fiscal revenues
- bank and market loans
- monetary expansion

	2009	2010	2011		2012	
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	(Percent of GDP)					
Total revenue and grants	21.7	22.0	22.6	22.4	23.4	23.4
Revenue	18.6	19.4	20.2	20.2	21.1	20.7
Tax revenue	18.0	18.8	19.0	18.9	20.0	19.5
Income tax	4.8	5.3	5.2	5.1	5.2	5.2
Taxes on goods and services	10.2	10.9	10.6	10.7	11.6	11.5
Taxes on petroleum products	3.0	2.6	3.2	3.1	3.2	2.8
Nontax revenue	0.6	0.7	0.7	0.7	0.7	0.7
FSE			0.6	0.6	0.5	0.5
Grants	3.0	2.5	2.4	2.2	2.3	2.7

- Fiscal revenues
  - foreign trade taxes – usually custom duties
  - corporate tax
  - income tax
  - wealth tax
  - VAT
- Non fiscal revenues
  - sale or lease of real estate
  - royalties on mining
- seigniorage
- subsidies, donations, development aid



# Aid dependence

## The case of Rwanda

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	2008/09	2009/10	2010/11	2011/12 Country Report Prel.	2011/12 Rev. Proj No. 12/15	2012/13 Country Report No. 12/15
(Percent of fiscal year GDP)						
Revenue and grants	24.3	25.7	24.5	25.2	25.1	24.5
Total revenue	14.9	12.6	13.7	14.1	13.8	14.2
Tax revenue	13.1	12.1	13.1	13.0	12.7	13.5
Direct taxes	4.7	4.8	5.1	5.2	5.0	5.5
Taxes on goods and services	6.5	6.3	6.9	6.8	6.6	7.1
Taxes on international trade	1.9	1.0	1.1	1.0	1.0	0.9
Nontax revenue	1.9	0.5	0.6	1.1	1.1	0.7
Grants	9.3	13.2	10.7	11.1	11.3	10.3
Budgetary grants	6.0	9.1	6.1	6.5	6.8	6.3
Capital grants	3.3	4.1	4.6	4.6	4.5	4.0
Of which: Global Fund	...	...	0.0	1.8	1.7	1.4



# Public expenditures

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(Percent of GDP)						
Total expenditure and net lending <sup>1</sup>	26.7	27.1	28.8	29.0	28.9	29.8
Current expenditure	16.5	15.6	17.4	18.1	16.3	17.3
Wages and salaries	6.0	6.2	6.1	6.3	6.0	6.2
Interest payments	0.8	0.9	1.2	1.5	1.5	1.5
Other current expenditure	9.7	8.5	10.1	10.3	8.8	9.5
Of which: goods and services	4.8	4.6	5.1	5.2	5.2	5.1
Of which: transfers and subsidies	4.7	3.8	4.8	4.9	3.4	4.3
Of which: energy and food subsidies	1.0	0.0	2.0	2.0	0.6	1.6
HIPC and MDRI current spending	0.1	0.2	0.2	0.2	0.2	0.2
Capital expenditure <sup>2</sup>	10.1	11.6	10.9	10.5	12.7	12.6
Domestically and nonconcessionally financed	6.1	6.9	6.8	7.0	7.6	7.0
Externally (concessionally) financed	3.9	4.7	4.1	3.6	5.2	5.6
Net lending	0.1	0.0	0.5	0.4	-0.1	-0.1

# Budget balance and financing

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Total expenditure and net lending <sup>1</sup>	26.7	27.1	28.8	29.0	28.9	29.8
Primary fiscal balance	-4.1	-4.2	-5.1	-5.2	-4.1	-4.9
Overall fiscal balance						
Payment order basis, excluding grants	-7.9	-7.8	-8.6	-8.9	-7.8	-9.1
Payment order basis, including grants	-4.8	-5.2	-6.2	-6.7	-5.6	-6.4

# Other balances

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## ■ Primary balance

$$\text{primary balance} = \text{fiscal balance} + \text{interests}$$

... in other words, we subtract expenditures from revenues except the interests on public debt

## ■ Consolidated public balance

... which sometimes can include public firms, local administrations, etc.



# Debt restructuring

## A little bit of history

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- 1956: Paris Club
- 1970s: London Club
- multiplication of sovereign creditors, lack of coordination mechanism
- 1989: Brady Plan (17 countries)



# Debt cancellations

## Results of the HIPC initiative

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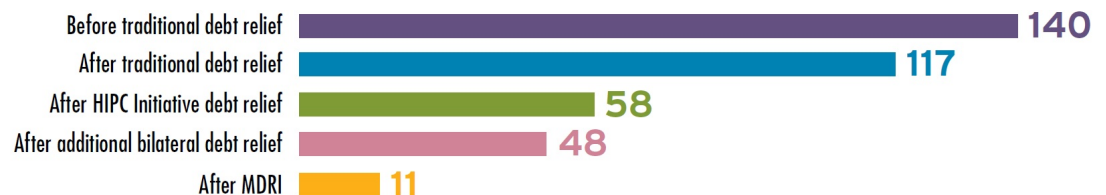
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# Debt cancellations

Cameroon's example

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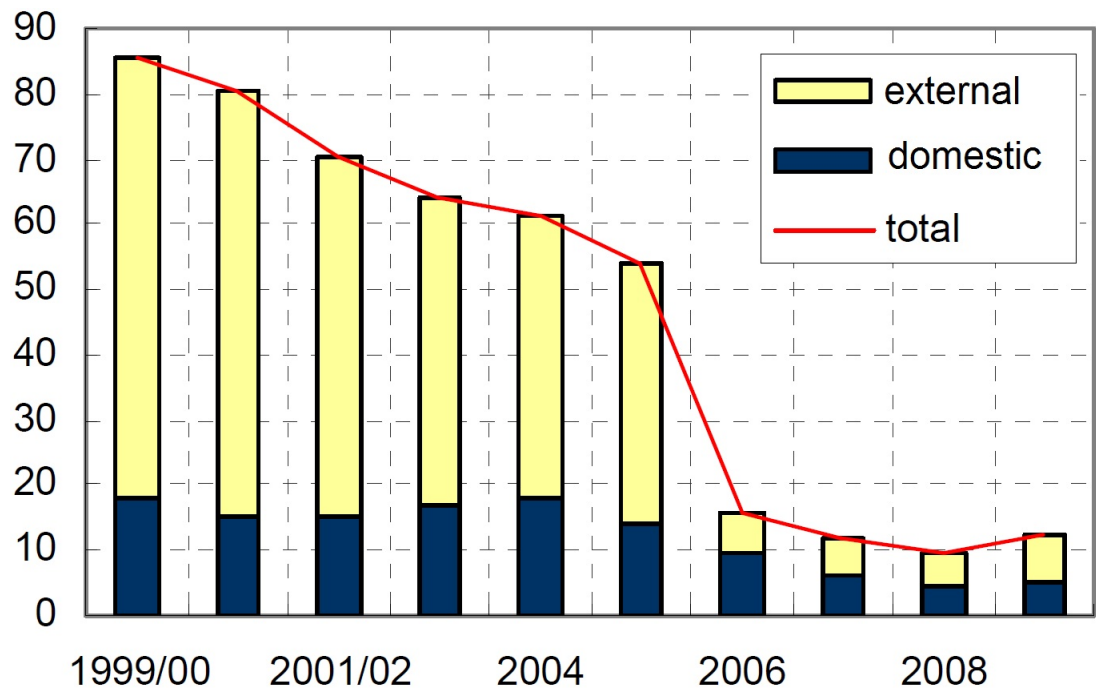
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# Why cancel the debt ?

Reassess priority expenditures

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## Stated goals of debt cancellations

- relaunch the spendings aimed at reducing poverty: health, education, and rural infrastructures
- institutions and governance reform

## Empirical measure of the success of these programs

- no measurable impact of cancellations on public expenditures
- some weak evidence of an increase in health and education spendings: success of conditionality?





# The risk of getting into too much debt

## The debt sustainability framework (DSF)

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- Objective: avoid that countries get again into too much debt
- Objective: provide countries with a tool to better take into account shocks in policies
- central scenario of public debt forecast
- stress scenarios that influence the debt trajectory
- that take into account the institutional quality



# The DSF, an adequate tool ?

## The disruptive potential of debt

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- an increasing ratio debt over is not always bad
- and in any case, debt indicators and CPIA are insufficient
  - they don't take into account the exposure to external volatility
  - they don't take into account correlated shocks
  - they need of a really stochastic approach
- finally they can't be applied to non-DAC countries



# Debt intolerance

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- Sovereign default
  - a purely opportunistic decision?
  - or rather a partial (and costly) insurance against adverse macroeconomic shocks ?
- Can we talk about debt intolerance ?
  - some countries with moderate debt ratios
  - are perceived as being riskier  $\implies$  higher spreads, sharper credit conditions
  - default recurrence in some countries



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# Domestic and external anchoring

## Mundell's incompatibility triangle

### Stabilization policies

Arthur Silve

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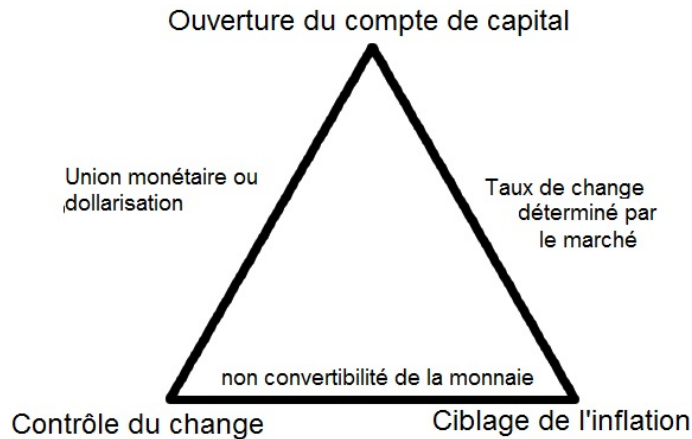
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# A monetary or an ER policy ?

Relative merits in terms of stabilization

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- to expect fine-tuning of the economy is probably illusory in DCs (overestimated importance of the regime choice)
- but the different ER regimes have different merits
  - fixed ER  $\implies$  reduces the impact of a financial shock
  - floating ER  $\implies$  avoids the transmission of a productive shock
- and create different difficulties
  - fixed ER: need of fiscal austerity. Otherwise, financial crisis
  - inflation targeting: need of excellent institutions



# Example: Poland

monetary or ER policy?

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- 1990: fixed ER
- 1991: devaluation and introduction of a crawling peg
- 1995: accession to the OECD, partial liberalization of the capital account and crawling band
- 1998: inflation under control, inflation primary target
- 2000: floating ER



# Monetary policy and inflation

Vietnam – Source for the graph: AS

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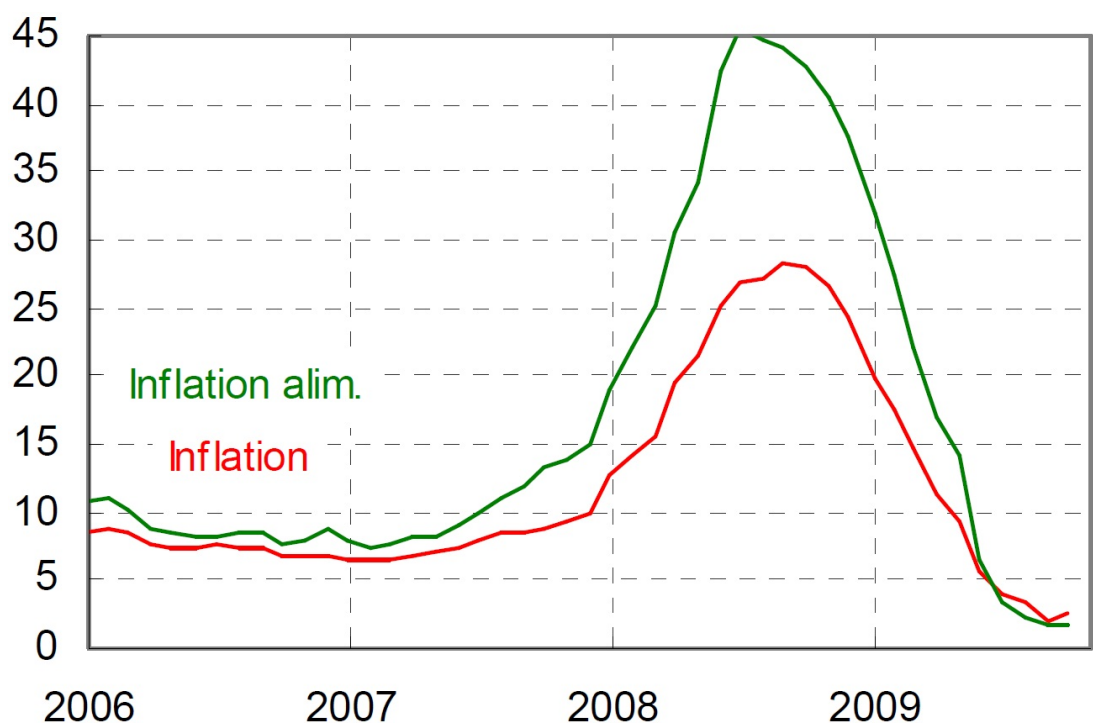
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# Inflation targeting in Brazil

graph from the 2011 F&D

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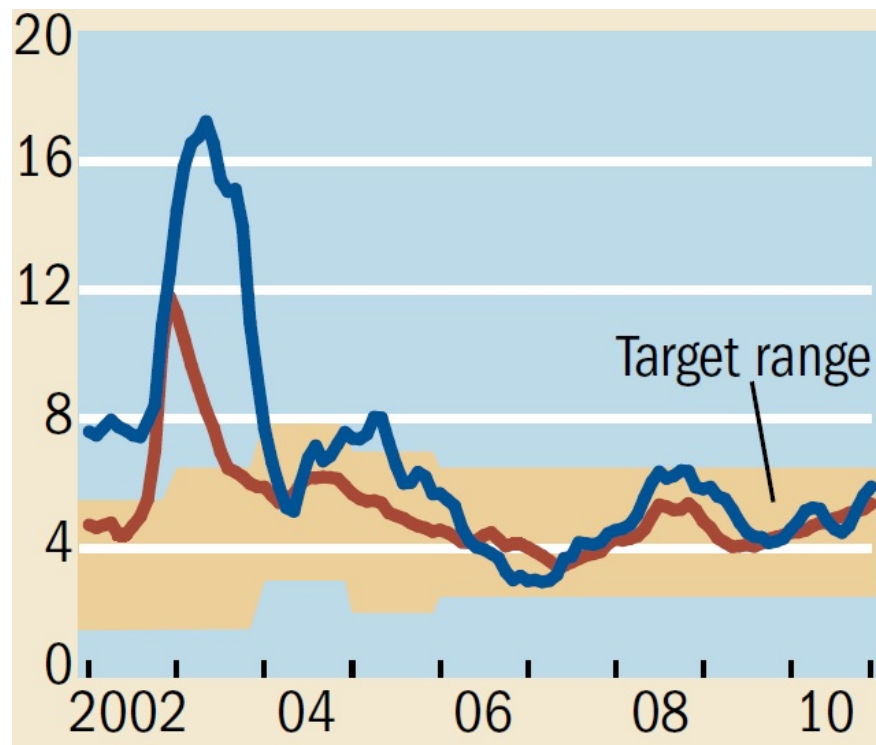
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# Implementation of inflation targeting in developing countries

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- need of excellent institutions, difficult to implement
- but contributes also to increase the state's institutional capacity and encourage fiscal austerity
  - $\Rightarrow$  threshold effects
- less vulnerable to external shocks
- the currency value is determined in view of domestic determinants

# The exchange rate

## Back to Vietnam

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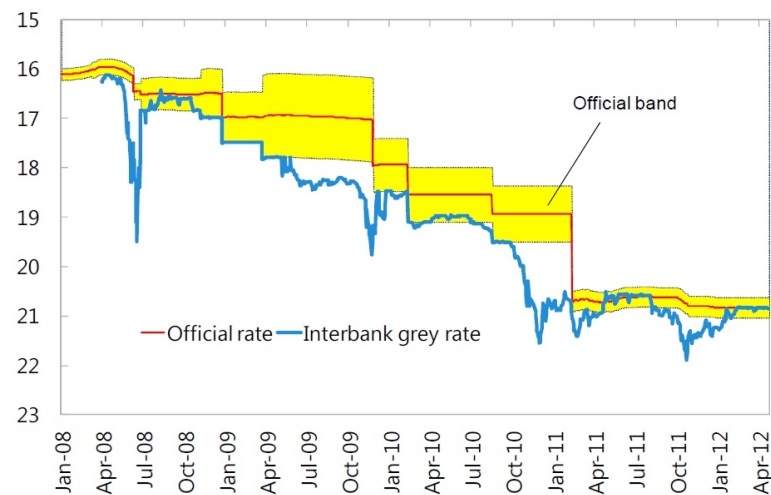
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The exchange rate is the price of a currency in another currency:

- higher ER  $\iff$  weaker currency
- under-evaluation  $\iff$  advantage to exporters



Source: article IV. y: x1000 VND/USD

# Reflect fundamentals

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The ER is usually fixed in order to reflect certain fundamentals

- PPP
- balance the current account, extending the latter to goods, services and factor revenues
- 3 goods model
- portfolio model (of assets and revenues)

not to mention models describing the ER volatility

# The difficulty of maintaining an ER anchor

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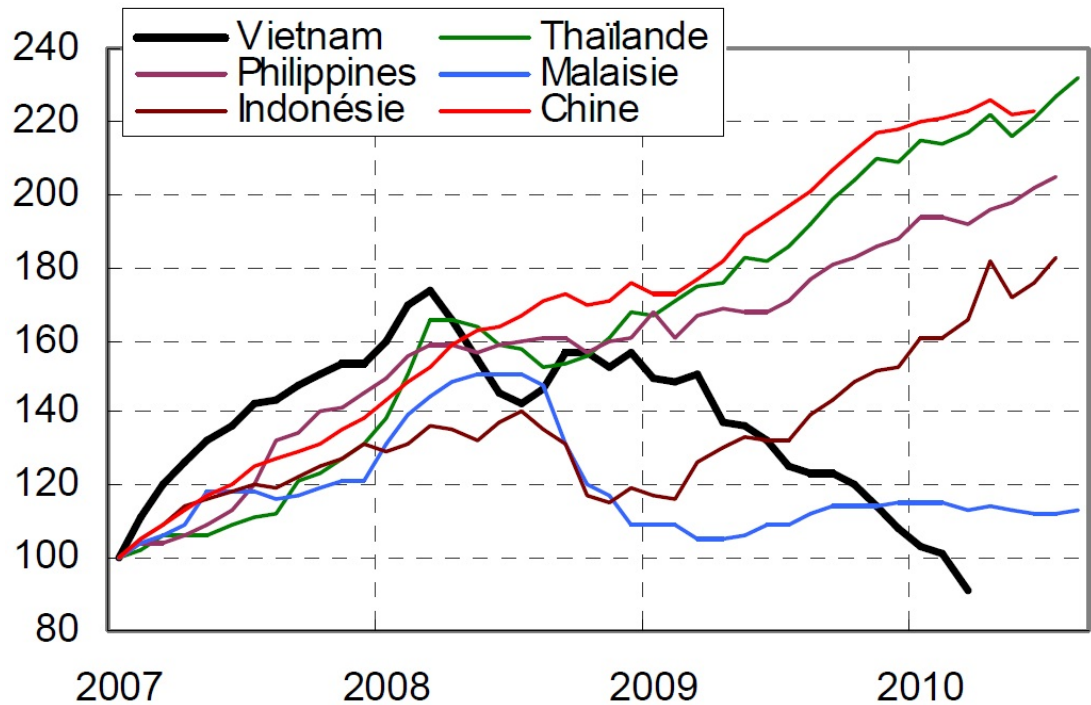
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Source: AS as from several central banks

# The exchange rate regimes

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- dollarization / adoption of another currency
- monetary union
- currency board
- fixed ER, crawling peg
- managed float
- free float



# Operational conclusion

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A key role of the fiscal policy, direct and indirect

- on the stabilization (or the destabilization)
- on the level and the form of redistribution

Different institutional choices to anchor anticipations. . .

- Inflation targeting: threshold effects in terms of the institutional capacity
- ER anchoring: issue of the liquidity in foreign currency

. . . more or less adapted to

- different type of shocks (real shocks, financial shocks, external or domestic shocks)
- different levels of institutional capacity



# . . . What next ?

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The international crisis confronted developing countries to a big external shock. Indeed, they often implemented counter-cyclical policies

- fiscal stimulus
- monetary constraint loosening
- capital flows monitoring

For most of them, the biggest shocks is behind them.  
The aim now is to reconstitute the buffers

- rebuild official reserves
- strongly reduce fiscal deficits
- avoid inflation going out of control