Fiscal and Monetary Policy Coordination in an Inflation Targeting Regime

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Introduction

- Inflation Targeting adopters increasing
- 7 Developed Countries;
- 17 developing countries
- 27 candidate countries
- SSA Candidate countries: Angola, Botswana, Kenya , Mauritius, Nigeria, Sudan, Uganda, Zambia
- IT creeping into IMF Programme Requirement with introduction of inflation consultation criteria in IMF Programme Requirements for Turkey

Introduction ctd

- Elements of IT
- Absence of other nominal anchors such as exchange rate or nominal GDP; Nec. Cond
- Policy instrument independence;Nec. Cond
- Developed financial market Nec. Cond
- Policy transparency and accountability; Nec Cond.
- An institutional commitment to price stability; Nec. Cond.
- **Absence of fiscal dominance. Suff. Cond**

Introduction ctd

- IT policy framework involves public announcement of inflation targets coupled with **credible** and accountable commitment on the part of government policy makers to the achievement of these targets.
- Complementary Fiscal Policy therefore an imperative for successful IT policy framework

FP and MP Coordination in IT Regime

- Two forms of Central Bank Independence
- Goal Independence and operational independence
- IT requires supportive/complementary FP designed to eliminate risks of fiscal dominance
- UK: Explicit Goal of FP designed to prevent fiscal dominance: Govt borrow only to finance investment (golden rule); public debt/gdp ratio to be sustainable (40% norm)
- NZ: Fiscal Responsibility Act require govt to act in accordance with principle of responsible fiscal management; public debt to be held at a prudent level and future taxes to be predictable

FP and MP Coordination in IT Regime

- Successful IT Regimes Require:
- Central bank independence
- MPC to be fully and regularly informed, in advance, of FP stance/impending actions
- FP should secure fiscal discipline and avoid fiscal dominance

Issues in Complementary FP: Developing Countries

- Weak revenue base an attribute of weak economic structure
  - South Africa
  - Mauritius structurally ready?
  - Nigeria?
- Underdeveloped financial system
- Need to convert on-going resource rents from transitory to permanent revenue sources to prevent fiscal dominance when the rent evaporates

Issues in Complementary FP: Nigeria

- Exogenous Revenue
- Sticky Expenditure structure
- Both make govts very vulnerable to external shocks that can compel fiscal dominance and threaten sustainability of IT
- Challenges of a Federal System

Complementary FP: Options for Nigeria

- Diversify economic base away from oil to broaden tax base
- Ensure that the PS Finance is part of MPC: Section 12 as it is does
- MPC should continue to take supplementary policies to provide incentives for banks to lend to real sector and lower interest rates spread

Complementary FP: Options for Nigeria

- Fiscal Responsibility Act good as it contains oil-based fiscal rule, debt management framework and public borrowing that applies to all levels of govt
- Consider possibility of:
  - Petroleum Fund Act
  - Petroleum Reserve Act
  - National and Supplementary Revenue Act to underpin expenditure
  - State and Supplementary Revenue Act to underpin expenditure

Conclusion

- Fiscal dominance can compromise credibility of IT; indeed, it can result in a veto
- To avoid it in developing countries, it is imperative to :
  - diversify the economy and broaden the tax base,
  - for resource rent economies try to convert the transitory revenue source to a permanent one
  - for Nigeria, consider additional legislations to further secure fiscal discipline at all levels of govt.