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
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.