INSTITUTE OF POLICY STUDIES

STABILISATION AND GROWTH
SOME NOTES ON THE ROLE OF CREDIBLE POLICIES

By
Anoop Singh

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D.F.C.C. Building - 2nd Floor
73/5, Galle Road
Colombo 3
Sri Lanka

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Stabilisation and Growth

Some Notes on the Role of Credible Policies

By

Anoop Singh[1]

It is commonplace today to hear many observers and policymakers decrying stabilisation as both 'bad' and inimical to growth. This perception has clouded important issues and, in key instances, frustrated the formulation of economic policies appropriate for self-sustaining growth. In my remarks today, I intend to argue that (i) stabilisation is usually a prerequisite to growth; (ii) stabilisation policy must be visibly credible to be effective; (iii) it is non-credible stabilisation that is either self-defeating or increases the costs of adjustment; and (iv) elements of a credible policy are well known, usually require greater attention to the quality of fiscal adjustment, and should guide adjustment policy.

I. WHY STABILIZE?

Why the need to stabilize? In most economies, the need to stabilize arises when the resource constraint becomes binding and the economy is no longer able to live beyond its means without intolerable inflation or an unsustainable external deficit. Of course, tolerance and sustainability vary from country to country, depending on historical experience and political, economic and social conditions. Once inflation erupts or current account deficits exceed sustainable net transfers, decisions concerning the nature and timing of stabilisation involve both political and economic considerations.

In most economies facing such a need to stabilize, with unsustainable inflation or external payments imbalances, a fiscal problem is commonly the cause. The fiscal problem is nothing other than the budget constraint *applied to the entire public sector* of an economy. It arises, simply, because public spending exceeds available public resources. Of course, these fiscal pressures may have stemmed from a variety of sources: domestic and external, endogenous or exogenous. Thus, overspending could be -- and usually is -- one cause; sudden changes in the external environment, such as real interest increases and terms of trade declines, are another. In most of these cases,

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1 The views expressed are personal and do not, in any way, reflect official positions of the World Bank.

some form of stabilisation -- bringing domestic demand in line with available supplies -- is required. Of course, it helps to have access to concessional external financing that augments supplies and reduces the imbalance needing correction.

Why should stabilisation not be postponed? Unless the initial imbalance is due to a fully reversible event -- and can, in the interim, be financed -- the alternative as we have seen, is inflation or external deficits. Usually, these latter developments, by altering other relationships or perceptions in the economy, will tend to magnify the size of the initial imbalance. The success stories of growth and development, such as in East Asia, are clear reminders that longer-term growth policies require a firm foundation of macro-stability. In an unstable macro-environment -- with high, variable, or uncertain inflation and payments imbalances -- the long-term sustainability of policies and reforms will remain in doubt. In such an environment private investors will expect a change of policy -- knowing with complete conviction that the imbalance will ultimately need correction -- but not knowing how it will be done. They will prefer to wait for new and sustainable relative prices and incentives to be established before taking irreversible investment decisions. Quantitatively, there is a cost to investing and a value to waiting whenever substantial uncertainties apply to the course of future policies. Calvo[2] has rightly recognized this phenomenon for what it is -- a distortion in the economy, that needs correction like other economic and social distortions to growth.

II. A FRAMEWORK FOR STABILISATION

A variety of approaches have been used to focus on the fiscal role in stabilisation. They are generally based on national accounts principles that require that net expenditures in one sector (say, the public sector) have to be met by net savings in other sectors (the private sector) or by an external current deficit. Thus, we have the familiar identity:

Government Sector = Private Sector + Foreign Sector

This approach has a number of advantages -- among them, that it focuses on the size of the public sector deficit and, more generally, on the sharing of the burden of adjustment between the public and private sectors. Its drawback, as we shall see, is that it does not consider the microeconomics of policies underlying the aggregate balances. That requires a disaggregation of the basic identity and attention to factors affecting sustainability of the balances.

This starting point can, nevertheless, be used to construct a progressively more elaborate (and disaggregated) framework that allows consideration of essential and policy-related components of the fiscal deficit, such as tax and expenditure decisions, financing alternatives, and other policies that may be used to pursue stabilisation.

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2 Calvo, Guilermo, "Notes on Credibility and Economic Policy," (mimeo, IMF, 1988); and also Dornbusch, Rudiger, "Notes on Credibility and Stabilization," NBER Working Paper, No. 2970 (National Bureau of Economic Research, Dec. 1988).

We will use the following notation in constructing the framework, where all variables are expressed in percent of GDP:

D = Consolidated deficit of the public sector

G = Public sector expenditure, excluding interest payments

T = Public revenue

i = Nominal interest rate on domestic public debt

i* = Nominal interest rate on external public debt

B = Face value of domestic public debt

B* = Face value of external public debt

$\triangle$ = Increase in a specified variable

M = Base money

NFA = Net foreign assets of the Central Bank

F = Stock of net foreign liabilities of the private sector

TR = Official transfers

NICASET = Current account surplus, excluding transfers

Let us consider the fiscal deficit from its financing alternatives:

$$D = G + iB + I^*B - T = \text{Financing}$$

$$= \triangle M + \triangle B + \triangle B^* + T - \triangle NFA \qquad (1)$$

This can be adjusted to yield a more disaggregated version of the basic identity we started with:

$$\triangle NFA - [\triangle B^* + \triangle F + TR] = [T - G - iB - i^*B^*] + [\triangle M + \triangle B - \triangle F] \qquad (2)$$

Again the external current balance (the left-hand side) is equated with the sum of net public sector savings (the first term on the right) and net private sector savings (the second term on the right, which comprises all outside wealth other than claims to capital and inventories that are netted out in "net" private sector savings). This framework allows us to discuss issues such as the implications of money versus bond financing, capital flight, etc., that must be considered in the context of a stabilisation policy.

It may be useful to work with a narrower measure of the external balance than the current account, namely, the net resource flow which is defined as the current account balance less foreign interest payments (NICASET). Thus, adjusting the above identity, we have:

$$NICASET = [T - G - iB] + [\triangle M + \triangle B + R] \qquad (3)$$

The first term on the right allows a decomposition of the public sector deficit into its primary deficit.[3] R is the residual term, $(i^*F - \triangle F)$, and would include errors and omissions elsewhere in the framework together with changes in the private sector's net external assets.

The usefulness of this framework in analyzing the tradeoffs available to the government in stabilisation is directly related to the accuracy with which data can be fitted to it. The most important is the definition of the public sector. The central government budget usually understates -- by a wide margin -- the total claims by and on the public sector. Most economies have large financial and nonfinancial public enterprises and institutions that depend heavily on the central government budget and that also undertake fiscal or quasi-fiscal activities that are an integral part of the public sector's total demand on the economy. In these cases, it is essential to define the public sector as inclusive of the most important public enterprises and financial institutions judged to be undertaking quasi-fiscal activities. Central Bank deficits should be part of the public sector since they must ultimately be borne by the private sector. Thus, for the above framework, it is the *consolidated public sector* deficit that is needed.

This is more easily said than done. In many countries -- especially during times of extreme financial pressure -- information on the activities of a large number of autonomous government entities is rarely available with the completeness or timeliness that is required for assessing the full dimension of the fiscal problem. Even a framework for identifying the nature and extent of Central Bank losses, much less projecting them, rarely exists. Where inflation is present, accurate measurement of the real fiscal deficit becomes further complicated. An essential first step in embarking on stabilisation policy is, therefore, accurate measurement of the evolving fiscal balance.

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3 The primary deficit (T-G) is also called the "non-interest deficit." It focuses on the net indebtedness of the public sector.

This framework makes it clear that a stabilisation policy targeted at reducing the external deficit, must involve a net positive change in the consolidated public sector balance or increased net private savings (inclusive of the private sector's holdings of foreign assets). Stabilisation therefore requires: (i) higher taxation; (ii) reduced public spending; (iii) lower real interest payments on domestic public debt; (iv) the mobilization of revenue from money creation; or (v) increased private sector holdings of domestic and foreign assets. Stabilisation policy involves making these choices. The manner in which these choices are made and popular perceptions about their sustainability, have important implications for private sector investment behaviour and, thereby, for growth.

III. CREDIBLE VERSUS NON-CREDIBLE STABILISATION

A successful stabilisation policy is one that achieves the targeted external adjustment (or, put differently, the reduction in domestic demand) at minimum cost to the economy. Output and inflationary costs are usually the main costs considered. In a successful stabilisation, domestic resources are stimulated to move toward the tradeable goods sector while domestic demand is reoriented toward the nontraded goods sector. In this way, domestic output and employment are preserved -- provided these shifts in resources and demand actually do take place. Two key conditions required for this are: a realignment of relative prices, namely, a real exchange rate depreciation, and the maintenance of investment.

In this note, I will focus on some of the determinants of investment -- especially private investment -- that have usually been a major casualty of many stabilisation programs, leading to an eroding of growth. In these cases, a revival of investment is a prerequisite for an economic recovery. For a number of reasons, it is private investment that is expected to play the leading role in this revival.[4] This makes it imperative to consider why new private investments often remain elusive, *even though there are the resources to invest* (i.e., the "savings-gap" is not *genuinely* binding).

The fact is that private investment decisions -- especially of the "irreversible" or fixed type required for new additions to capacity, employment, and growth in the manufacturing sector -- are critically influenced by expectations of profitability. Unless these expectations exceed alternative uses of private savings, such as in more liquid foreign assets, the necessary private investments will not be made. This sounds quite obvious and rational. Less obvious, however, is an appreciation of the complex factors that influence expectations of profitability and the extent to which they stem from fiscal policies. Put differently, in the framework set out above, the behaviour of private savings and investments depends on both the magnitude *and the quality* of the public sector adjustment. It is well known that if the magnitude of the public sector adjustment falls short of the desired shift in the external current balance, the greater is the probable

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4 This is so for at least two kinds of reasons. First, given the fiscal crisis in these economies, and the competing claims for fiscal resources, public investment--especially in the industrial sector--can hardly acquire a leading role. Second, the experience of successful adjustment and growth economies points precisely to private investment as being the basis of their ability to raise manufacturing, export, and overall growth rates.

displacement of private investment. However, if the public sector adjustment is judged to be non-credible, or unsustainable, then expectations of alterations to policies, or undesirable outcomes will reduce ("tax") the profitability of private investment. If sufficient numbers of investors share this perception of unsustainability, and fear outcomes that will erode the basis of their investment decisions, then a crisis of confidence can quickly develop. Self-fulfilling pessimism can therefore trigger an investment collapse, even where the underlying stabilisation and adjustment policy was a viable one. Thus, it is not simply that policies have to be good. They must also have credibility, and there must be confidence in the government's ability to stick by them and see the program through. This approach to private investment has stimulated the development of a number of models that assess the impact of various kinds of uncertainty on the probability of program success.[5]

Two broad categories of uncertainties may be distinguished: *exogenous* and *endogenous* (or systemic).[6] Exogenous uncertainties can be of several types. For example, investors may fear exogenous events -- in particular, sudden changes in external financing conditions, interest rates, terms of trade, etc., and their impact on domestic adjustment policy. Debt overhang may also reduce new -- mainly foreign -- investment by the "devaluation" effect it could have on new equity, and on loan values of prevailing secondary market discounts on existing external debt.

This note is primarily concerned with uncertainties of the endogenous kind. These may be of two kinds. The first may arise even with a relatively well designed adjustment program, if investors believe that the government is too weak to see the package through, or that significant vested interests or polarized groups would hinder program implementation and increase adjustment costs. Then, they may prefer to avoid irreversible investments or demand a high premium (investment subsidies). In either event, new and desirable investment may not be forthcoming in sufficient amounts for the program to succeed. This kind of credibility problem -- common in the initial stages of most adjustment programs -- can only be overcome by steadiness in implementation, and the avoidance of forced or inherently non- credible policies.

It is the second group of uncertainties -- the policy-specific type -- that is usually the basis of unsuccessful stabilisation. These arise whenever the fiscal deficit is reduced by inefficient revenue or expenditure measures that are perceived as unsustainable, or obviously temporary. Thus, expenditure reductions achieved by an excessive compression of real wages, postponements of essential maintenance and infrastructure expenditure, or arrears, to give just a few examples, will not be credible fiscal reforms. Fiscal deficit reductions secured in this way will, most likely, result in fears of future --

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5 See, for example, Blackburn, Keith and Christensen, Michael, "Monetary Policy and Policy Credibility: Theories and Evidence", Journal of Economic Literature, March 1989; Rodrik, Dani, "Public Uncertainty and Private Investment in Developing Countries, "NBER Working Paper No. 2999 (National Bureau of Economic Research, June 1989); and Blejer, Mario I. and Ize, Alan "Adjustment Uncertainty, Confidence and Growth: Latin America and the Debt Crisis." (mimeo, IMF 1989)

6 This distinction between different categories of uncertainty is not necessarily mutually exclusive. Other categorizations have also been made, for example, by Blackburn and Christensen (March 1989).

and, as yet, unknown -- tax increases or of disorderly adjustment through inflation. Similar fears may be sparked off by revenue increases that reflect inefficient, dead-weight, or one-time measures, that are seen as political expediency in order to avoid tackling the underlying issues associated with a structural tax reform. Tanzi[7] has described as "fiscal tension" that component of the fiscal adjustment resulting from transitory or unsustainable measures. This fiscal tension is a measure of the correction that is needed through sustained and long-term policies in order to eliminate the non-credibility.

Returning to our simple framework above, what about the case when public sector (fiscal) adjustment, however attained, falls short of the needed external adjustment? In this case, governments can attempt to transfer resources from the private sector by the issuance of domestic debt ($\triangle$B) or by reliance on inflationary finance ($\triangle$M).[8] These choices generally also have considerable potential for upsetting credibility in the adjustment process and holding back new private investments.

Reliance on inflationary finance would, of course, be the antithesis of stabilisation policy and representative of its failure. Beyond a certain, and usually limited, threshold, attempts to expand base money will result in inflation that would erode fiscal adjustment, and risk sparking off an inflationary spiral as expectations lead to a renegotiation of contracts drawn up in nominal terms.

More subtle is a policy of increased sales of government bonds as a substitute or supplement to fiscal adjustment. It usually results in higher domestic interest rates, an increasing domestic debt service burden on the public sector, and progressively shorter maturities of government bonds. The longer this policy is pursued as an alternative to fiscal adjustment, the greater its long-term costs in terms of credibility. This is because of well-founded fears that the government will, eventually, either have to run budget surpluses to meet service payments on an expanding domestic debt., or resort to inflationary financing. Investors will fear the uncertainty of future policies to achieve budget surpluses, but they will fear much more the probability of future inflation. In either case, investors will demand an increasing risk premium in bond interest rates that will add to the fiscal problem while, at the same time, deterring private investment. More formal treatment of debt dynamics has concluded that sustainability of bond financing usually becomes an issue, and reduces credibility, whenever the real interest rate exceeds the economy's growth rate.

Finally, we should consider situations where components of stabilisation policy are, or appear to be, in conflict. This can easily happen and is implicit in the above discussion.

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7 Tanzi, Vito "Fiscal Policy and Economic Reconstruction in Latin America, "IMF Working Paper 89/94, November 1989.

8 Inflationary finance, or revenue from money creation, is the term $\triangle$M in our framework. This can be decomposed into its components, the inflation tax and the change in real balances. Thus,

$$\triangle M = Mt - Mt-1 = Mt - Mt-1\,(1 + \pi) + \pi(Mt-1)$$

where π = inflation between end-period t-1 and t, and each term is expressed in per cent of GDP.

For example, the fiscal authority may be unable to reduce present and potential budget deficits, or convince others of its intent to do so, but the monetary authority could seek a tight monetary policy through the issuance of its own debt instruments (also part of $\triangle B$ in our framework). The result is, again, reduced credibility in the overall macroeconomic program. Such a program would require a progressively higher real interest rate on Central Bank securities (and the whole of domestic public debt) as rational agents recognize, in the manner explained above, the future consequences for inflation or budget measures. This explains the phenomenon of continued high real interest rates despite reduced *actual* inflation. The prospect of future large fiscal deficits and their possible monetization keep inflationary *expectations* high until there is greater confidence in the fiscal future. In this environment, flight capital may be induced to return *temporarily*, but it would most likely seek out the high- yielding government bonds rather than new and irreversible investments. At some point, flight capital would leave again, when the growth in the domestic public debt reaches another threshold, triggering a crisis.

Conflicts can also arise with external policies. A policy of constantly depreciating the exchange rate to maintain export competitiveness (and facilitate a shift in the external current account) in the face of fiscal laxity and inflationary finance is not a sustainable basis for orderly adjustment and growth. Distorted and unpredictable changes in relative prices will deter fixed new private investments as surely as other conflicts in macroeconomic policy.

IV. CONCLUSIONS

The formal treatment of credibility is still at an early stage. Formidable problems need to be tackled regarding its identification, its time-dependence, and its quantitative effects (many of which will only be experienced with a lag) on observed relationships and data. Thus far, the literature has focused principally on financial -- notably, fiscal -- policies, although its most useful extensions appear to be in assessing conflicts between policies of different economic institutions involved in formulating and implementing a macroeconomic program. Nevertheless, the discussion thus far has served to highlight the central position of public sector fiscal policies in stabilisation, and the effects on private investment and growth. Some key conclusions: (i) stabilisation policies need to be credible to be successful; (ii) slippages in fiscal policy have usually been at the root of failed stabilisation programs; (iii) good and credible stabilisation will usually raise and not deter private investment; and (iv) fiscal policy has a key role in reducing uncertainty and rebuilding confidence.

Good stabilisation requires that equal attention be given to the quality of fiscal adjustment as to its quantity. What principles can guide good stabilisation? One is expenditure control, particularly important in economies where the public sector is large. This means that efforts should be concentrated on reducing the size of government, including enterprises and entities outside of the central government. Of course, such reductions cannot be made a quickly as cuts in other expenditures. In this case,

credibility would still be served by the announcement of a sequential series of irreversible steps designed to curtail the fiscal burden of large government. The second is the priority of preserving public expenditure on operations and maintenance, and on infrastructure investment, over other kinds of new capital investment, particularly where the economy is emerging from a period of high fiscal and investment expenditure. Third, large cuts in real wages, achieved through inflation or wage policy, are counterproductive as they generally prove to be unsustainable. Fourth, where revenue generation is required, the focus should be on efforts to stimulate tax collection, reduce evasion and arrears, and eliminate inefficient and discriminatory taxes and tax incentives that distort incentives to save and invest.

Finally, it is important to recognize that efforts to increase the profitability of private investment must be matched by economic deregulation that expands the area of the economy in which the private sector may enter. This means reviewing domestic and foreign investment restrictions and approval procedures, and ending preferential tax and other incentives that discriminate between investors.