BCEAO
BANQUE CENTRALE DES ÉTATS DE L'AFRIQUE DE L'OUEST

Directorate-General of Economy and Currency
Economic Conditions and Monetary Analysis Department

Directorate-General of the West African Center for Training and Banking Studies
Research and Partnerships Department

Scientific Seminar of the Banco de Moçambique themed "Interactions between Monetary and Fiscal Policies"

(Maputo, June 14, 2024)

Speech by the Governor of the BCEAO

Avenue Abdoulaye FADIGA BP 3108 – Dakar - Sénégal

Tel. (221) 33 839 05 00 / Fax. (221) 33 823 93 35
courrier.bceao@bceao.int - www.bceao.int

Honorable Governor of the Banco de Moçambique,

Honorable Deputy Minister of Economy and Finance,

Honorable Board Members of the Banco de Moçambique,

Distinguished Representatives of Central Banks and International Institutions,

Distinguished Academia and Research Center Representatives,

Distinguished Guests,

Ladies and Gentlemen,

Good morning!

1. I am delighted to take part in this XV Scientific Seminar of the Banco de Moçambique, with the theme “Interaction between Monetary and Fiscal Policies”.

2. I want to extend this opportunity to thank the Banco de Moçambique for such a warm welcome and special attention dedicated to us. Allow me, on behalf of the eight countries of the Central Bank of West African States (BCEAO) here in attendance and represented by me, to thank you for your hospitality.

3. Yesterday, we visited the Banco de Moçambique Museum, which portrays the story of the Central Bank of the Republic of Mozambique. I welcome the great progress made since May 1975,

particularly symbolized by the majestic new tower of the Banco de Moçambique.

4. We have also seen this beautiful video regarding the launch, within a few hours, of a new series of the national currency, the Metical. Congratulations!

5. Allow me to express my profound gratitude to the Governor of the Banco de Moçambique, Rogério Lucas Zandamela, for inviting me to be the keynote speaker at this event. Our relationship dates back to when we both worked at the International Monetary Fund. I witnessed his brilliant career at this great international institution. I congratulate him on the performance of the Banco de Moçambique with regard to inflation, exchange rate stability and economic growth.

6. I also welcome the presence of representatives of central banks, regional and international institutions, as well as prominent figures from the academia. This scientific seminar is an excellent opportunity for economic policymakers and academics to discuss the major challenges facing the Mozambican economy, in particular, and the African continent in general.

Ladies and Gentlemen,

7. As is well known, the interaction between monetary and fiscal policy is a topic widely discussed in the economic literature (Keeper

(1991)[1]; Kuncoro and Sebayang (2013)[2]; António Afonso (2019)[3], Nabil and Francisco (2021)[4], Teles and Tristan (2021)[5], Liu and Su (2023)[6]. This debate has recently gained a renewed interest, driven by the economic and financial crises that have affected the world economy over recent decades.

8. The challenges associated with the coordination between the monetary and fiscal policies arise from the fact that their objectives may conflict. On the one hand, the central bank aims at price stability, while ensuring financial stability, through monetary policy, and on the other, fiscal policy aims to assure full employment, while ensuring sustainable public debt.

9. Certainly, as regards monetary policy, these objectives differ between central banks. In the United States, in addition to ensuring price stability, the Federal Reserve also aims to ensure full employment. In developing countries, especially in Africa, several factors must be considered. Sustainability of external accounts, exchange rate stability for countries with a flexible exchange rate regime, financial stability and strengthening financial inclusion are key concerns. In the case of the Banco de Moçambique, Article 3 of its Organic Law provides that its main objective is to preserve the value of the national currency and to promote a sound, modern and inclusive financial system. In addition, all the central banks on the

[1] "Equilibria under 'active' and 'passive' monetary and fiscal policies", Journal of Monetary Economics, Vol. 27, No 1, pp. 129-147
[2] https://www.econstor.eu/bitstream/10419/107951/1/818545747.pdf
[3] [3]https://www.researchgate.net/publication/330703191_Interactions_between_Monetary_and_Fiscal_Policies
[4] https://www.cemla.org/PDF/ic/2021-07-jrp/Dominicana_Lopez-Ramirez_JRP2020.pdf
[5] The monetary financing of a large fiscal shock", paper delivered at the Bank of Finland-CEPR 2021 Conference on New Avenues for Monetary Policy, 10-11 September
[6] "Fiscal stimulus under average inflation targeting", Federal Reserve Bank of San Francisco Working Paper 2022-22

African continent understand the importance of monitoring the State budget financing conditions, which are key players for economic balance and social stability.

10. My intervention will touch on three points:

- First, I will give a brief presentation of the instruments of monetary and fiscal policies as well as the constraints they face.
- I will then address the interaction between monetary and fiscal policies, with a particular emphasis on the effects of monetary policy on fiscal policy, on the one hand, and the influence of fiscal policy on monetary policy, on the other.
- I will end my presentation by outlining the different coordination strategies both in normal situations and in times of economic instability. I will take this opportunity to share the recent experiences of the West African Economic and Monetary Union (WAEMU) in coordinating monetary and fiscal policies.

Ladies and Gentlemen,

[Monetary and fiscal policy instruments and bottlenecks]

11. By definition, monetary policy refers to the regulation of liquidity in the economy by the central bank, to achieve its main objective, which is to ensure price stability, and ultimately preserve the currency's value domestically and abroad. In other words, without jeopardize the above factors, the implicit assumption is that low and stable inflation strengthens confidence in the currency, maintains the purchasing power of economic agents and reassures national

and international investors and savers who make intertemporal decisions.

12. To this end, central banks rely on policy rates and the supply of central money to act on the financing conditions of the economy and, consequently, on overall demand, and thus on price levels. The implementation of this policy may face structural constraints, such as an underdeveloped or absent capital market, and low financial inclusion.

13. Fiscal policy refers to government choices regarding the use of taxes and public spending to regulate the overall level of economic activity. Its key drivers include tax revenue levels and composition, on the one hand, and the level and allocation of state expenditures and public debt, on the other.

14. Fiscal policy constraints include public debt sustainability, the ability to mobilize tax revenues and the risk of crowding out that occurs when public financing reduces the availability of resources for private sector financing. In addition, other forms of constraints include the size of the informal sector and the low depth of the financial market.

Ladies and Gentlemen,

[Interaction between monetary and fiscal policies]

15. The interaction between monetary and fiscal policies arises from the fact that both policies have cyclical implications linked to their ability to influence economic growth, inflation, and the real

exchange rate.

16. Monetary policy affects fiscal policy through five main channels, namely:
    a. The cost of State loans in the financial market and with the banking system;
    b. The real cost of public debt through inflation;
    c. Real interest rates affecting capital flows in the economy;
    d. The real exchange rate which influences competitiveness and trade; and
    e. The dynamism of economic activity that determines the level of tax revenue collection.

17. In turn, fiscal policy interacts with monetary policy through various mechanisms, such as:
    a. The monetization of the budget deficit, which affects the ability of monetary policy to restrain inflation;
    b. Financing of the budget deficit which can lead to the crowding out of the private sector, and reduce the effectiveness of monetary policy transmission channels;
    c. The deterioration of external accounts due to exchange rate instability;
    d. A debt crisis that would threaten banking and financial system stability.

Ladies and Gentlemen,

[Monetary and fiscal policy coordination strategies]

18. Therefore, the interaction between monetary and fiscal policies

requires coordination, insofar as these two economic policy drivers operate on different timeframes, in terms of time requirements for decision-making and the transmission of effects to the real economy. The absence of coordination or insufficient coordination between these two cyclical policies could pose a threat to their effectiveness and credibility and, consequently, create factors of vulnerabilities and macroeconomic instability.

19. I will reference three (3) types of interactions, identified in the literature, between monetary and fiscal policies, before presenting the best practices worldwide regarding the coordination between these policies.

20. The first form of interaction consists in fiscal policy dominance. This dominance refers to a situation in which the pressure exerted by fiscal policy on the monetary policy of a central bank leads it to participate, directly or indirectly, in the financing of public expenditures, at the risk of not complying with its objectives, particularly price stability. In practice, this is a situation in which monetary policy sets out to guarantee the State budget solvency, thus jeopardizing its main mandate of price stability.

21. The second form of interaction is characterized by monetary dominance, which represents a situation in which the monetary authority is focused on complying with its price stability mandate, without considering the fiscal authority restrictions. This situation can affect the State's ability to mobilize resources and induce an excessive increase in interest rates.

22. The third form of interaction is a decentralized coordination, which consists of an interaction between monetary and fiscal policies in which the state and the central bank closely monitor the reciprocal effects of their respective policies in the pursuit of their objectives. This is an optimal collaboration, which is often called a “Policy Mix” between the two policies. This approach is facilitated by the existence of a credible and transparent framework or rules for the fiscal and monetary authorities.

23. Globally, decentralized coordination of monetary and fiscal policies is considered best practice. It is based on independence *de jure and de facto* of the central bank and the adoption of fiscal rules. In fact, several empirical studies reveal that the independence of the central bank contributes to maintaining low and stable inflation, fostering savings and investment, thus averting dollarization of the economy, and ensuring financial stability. In addition, the adoption of fiscal rules (regulating fiscal deficits and state indebtedness) strengthens financial stability and facilitates private sector financing and growth.

24. Albeit decentralized coordination of monetary and fiscal policies is effective in normal periods, experience shows that in times of profound crises, more active coordination is required to maintain macroeconomic stability.

25. The international financial crisis of 2008-2009 and the COVID-19 pandemic are perfect examples. These two crises demonstrated the need to call on unconventional monetary policies in order to stabilize financial markets and support the fiscal bailout and

economic stimulus plans set up by States. In addition, the temporary suspension of fiscal rules allowed governments to respond quickly and robustly to the humanitarian, economic and social crisis.

26. Recent developments have made these interactions even more complex. I am referring to the high public debt, particularly domestic debt, the impact on financial stability caused by climate-related risks and innovation and technological development.

27. Climate has become a paramount matter for several African countries, particularly Mozambique, given the latest unfortunate events caused by Cyclone Freddy in March 2023. Similar to Mozambique, WAEMU countries face the effects of extreme climate events. These include the alternating droughts and floods, the invasion of the desert in the Sahel zone, scanty rainfall in some countries and floods in the production zones of other member countries.

28. Hence the urgent need to create mechanisms worldwide to allow these countries to mitigate and ease the impacts of these phenomena.

Ladies and Gentlemen,

29. I would now like to share the experience of WAEMU in coordinating monetary and fiscal policies.

30. The BCEAO is the common central bank of the eight WAEMU

countries, characterized by:

- A common currency to these eight states, the CFA Franc, with a fixed exchange rate against the Euro;
- A single banking law and a single banking supervision and control system;
- A single financial market.

31. The mandate of the BCEAO is to implement the common monetary policy, ensure price stability and ensure financial stability in our area.

32. WAEMU has a functional subregional financial market (Regional Securities Exchange) and a common development finance bank (West African Development Bank) whose main mission is to finance investments in different sectors of member countries.

33. The coordination of monetary and fiscal policies proved to be relatively peculiar. While the monetary policy of WAEMU is managed by a common and independent central bank, the countries of the region conduct autonomous national fiscal policies, but respecting the fiscal rules adopted in 1999 through a Convergence Pact, of stability, growth, and solidarity among member states. This pact caps the fiscal deficit at a maximum of 3 percent of GDP and the debt ratio at a maximum of 70 percent of GDP.

34. In the current context, the strategy for the coordination of fiscal and monetary policies in the WAEMU area resembles that of decentralized coordination between three main stakeholders: the

Ministries of Finance of the States (responsible for the conduct of fiscal policy), the BCEAO (responsible for the implementation of the Common Monetary Policy) and the WAEMU Commission (responsible for multilateral supervision and compliance with fiscal rules, as well as for the coordination of fiscal policies).

35. In practice, this coordination is carried out through an exchange framework that allows these three stakeholders to participate in each other's meetings of their decision-making bodies. Thus, the WAEMU Commission, represented by its President, may participate in the meetings of the Monetary Policy Committee. Likewise, the Governor of the BCEAO participates "as full member, with an advisory capacity, in the meetings of the WAEMU Commission". In addition, the central bank Governor has the power, before the Council of Finance Ministers, to submit general economic policies of Member States in fiscal and debt matters.

36. This coordination between monetary and fiscal policies was particularly illustrated during the COVID-19 crisis. In fact, during the pandemic, similar to other central banks worldwide, the BCEAO implemented extraordinary measures such as:
    a. The creation of several financing windows, in 2020 and 2021, coupled with interest rate cuts, in order to assist member states in the mobilization of resources and support their economic recovery plans;
    b. An authorization for banks to grant loan installment deferrals to households and businesses affected by the pandemic and faced with difficulties in paying their installments.

37. In addition, the implementation of the convergence Pact, i.e., the fiscal rules, was suspended to allow for a robust fiscal response.

38. These actions have made it possible to strengthen the resilience of WAEMU countries to the health crisis and ensured a recovery in economic activity. Economic growth in the WAEMU area was positive at 1.4 percent in 2020 and rebounded to the pre-crisis level of 6.0 percent in 2021.

39. However, from 2022 onwards, WAEMU faced major challenges associated with strong inflationary pressures and worsening international financial conditions.

40. These pressures have mainly arisen from various factors such as the Ukraine crisis, the impact of climate shocks and security crises within the Union.

41. To cope with these pressures and the deterioration in external accounts, the central bank has started to gradually increase its policy rates, as of June 2022. At the end of May 2024, its key policy rate stood at 3.50 percent and the lending rate at 5.50 percent.

42. In addition, the cumulative effects of various and successive crises have decreased fiscal space of member states. Fiscal deficits remained high, especially in 2022 and 2023, in a context of limited access to international financial markets, which led to significant incurring of debt in the regional financial market.

43. This situation has led to serious liquidity strains in the banking

system in 2023, placing governments at risk of default and triggering a sharp increase in public security yields.

44. Faced with this risk to financial stability, the central bank intervened in the secondary market and repurchased government securities in order to inject liquidity and ease tensions.

45. Thus, taking advantage of the framework for exchanges between the three coordination stakeholders, the central bank presented the monetary and financial situation to the WAEMU finance ministers in December 2023, including the risks to monetary stability, as well as the need to accelerate fiscal convergence and mobilize more external resources.

46. The implementation of the decisions arising from that consultation, namely the mobilization of Eurobonds and the progressive narrowing of deficits currently in progress, has made it possible to improve the situation, as of early 2024. Our foreign exchange reserves have started to recover, thus improving the outlook for WAEMU.

47. In short, the close and structured coordination between the two policies over the past two decades has enabled WAEMU to be more resilient against various crises. More recently, it proved instrumental in tackling inflationary pressures, preserving financial stability and strengthening the external balance. Inflation stabilized at 2.8 percent in the first quarter of 2024. The economic growth rate stood at 5.3 percent in 2023 and is expected to reach 6 percent in 2024.

Ladies and Gentlemen,

48. Before concluding, please allow me to share some important lessons learned from our experience.

49. The interaction between monetary and fiscal policies requires optimal coordination based on two main pillars:
    a. Central bank Independence (statutory and de facto);
    b. Adoption of fiscal rules by the State.

    These two pillars complement each other to avoid conflicting objectives. In times of crisis, this coordination must be more active in order to curb the economic costs of recession.

Ladies and Gentlemen,

50. These are some of the remarks that I wanted to share with you today on the theme of interaction between monetary and fiscal policies.

51. Finally, I would like to address my best wishes to the Scientific Seminar of the Banco de Moçambique and congratulate the winners for the quality of their research. I hope that they help to further the research work of the Banco de Moçambique.

Thank you very much for your attention!