Counter-Cyclical Monetary Policy Interventions in an Economy

A Paper Presentation to the Committee of Central Bank Governors in SADC

Abstract
The objective of this paper was to highlight the conditions necessary for a country to implement counter-cyclical policies. From the survey of literature, optimal counter-cyclical monetary policy is best undertaken by central banks with a good understanding of the transmission mechanism of their economies in addition to such countries having well-functioning financial markets. Also, countries with an institutional framework and infrastructure ideal for inflation targeting are more likely to successfully implement counter-cyclical measures. Further, countries that are small open economies should use counter-cyclical policy approaches as a way of dealing with global impulses that can adversely affect domestic economic activities. Moreover, counter-cyclical policies work favourably in the countries with strong macroeconomic fundamentals. In addition to the findings from the literature, we also propose that countries should have robust macro-prudential frameworks in place so that through the financial stability analyses undertaken they can get a feedback to guide on the appropriate policy response between pro- and counter-cyclical policy actions. This is in light of some problems in the economy that may arise, which generally may require pro-cyclical policy actions at that point in time in order to achieve financial stability. A survey of SADC member countries status on the conduct of counter cyclical policies shows that only one country has the necessary infrastructure and meets the conditionalities needed to undertake optimal counter cyclical monetary policy.
I. Introduction

1.1 Background

The concept of cyclicality as used in policy interventions refers to discretionary policy actions that either mimic the business cycles (trends in real GDP growth) or are innovative (opposite) to the business cycles. The policy interventions that mimic the business cycles are said to be pro-cyclical and those that are innovative to business cycles are referred to as counter-cyclical. Macroeconomic policies are directed at stabilising business-cycle fluctuations. Thus, counter-cyclical policies are so directed with a view of minimising output volatility and stabilising inflation at an acceptable level. A monetary policy approach that stabilizes both inflation and output around the set targets is counter-cyclical in nature. As the focus of monetary policy is to ensure price stability, this might not be easy without stabilizing output within the realm of the business cycles.

It is a general belief that fiscal policy in advanced economies is counter-cyclical either through automatic stabilisers (tax and welfare support) or discretionary actions while that of developing countries is inclined to pro-cyclicality (David, 2012). However, Egert (2010) has shown that in the OEDC, fiscal policy actions by countries with high public debt and high government deficits tends to be pro-cyclical, while countries that have low public debt and those which have surpluses are more inclined to conducting a counter-cyclical fiscal policy. Other studies on the subject include those done by Gavin and Perotti (1997), Braun (2001), Riascos and Vegh (2003), Gupta et al. (2004), and Talvi and Vegh (2004).

The pro-cyclical approach to policy management by many developing countries is due to, among others, credit constraint and the strong role of political economy. The issue of pro-cyclical fiscal policy orientation by developing countries is identified and reported by Strawczynski and Zeira (2007), Ilzetzki and Vegh (2008), Fatas and Mihov (2009) and Kasekende et al. (2010).

Africa’s fiscal policy orientation has been pro-cyclical1 save for the period soon after the onset of the global financial crisis, Kasekende et al. (2010). Research on South Africa’s cyclicality of policy before the global financial crisis has revealed conflicting results with regard to the cyclicality of monetary and fiscal policies. In Du-Plessis et al. (2007), the role of fiscal policy in the stabilisation of the South African economy was less favourable over the period 1994 to 2006 and showed little evidence of counter-cyclical approach as a fiscal stance. However, monetary policy was found to have contributed to the stabilisation of the South African economy over this period and therefore regarded to be counter-cyclical in nature.

It is generally believed that monetary policy by central banks that enjoy some measure of independence, particularly instrument independence, is counter-cyclical in nature if their objective is both price and output stability. Coulibaly (2012) has stated that institutional deficiencies as well as internal economic vulnerabilities explain most of the emerging market economies (EMEs) policymakers’ inability or undesirability to

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1 That is countries tend to cut expenditures when revenues are falling and increase expenditures when revenues are rising.
conduct counter-cyclical policy. These authorities have often been more concerned with preserving the credibility of policy, containing capital flight, and defending the values of their currencies.

1.2 What is the Underlying Concern Prompting the Study?

There has been some concern among the authorities in the SADC region as to when counter-cyclical policies can be implemented in an economy; and also, under normal conditions, should monetary policy with its lags be used to fine tune the economy? Thus, the objective of this paper is to highlight the conditions necessary for a country to implement optimal counter-cyclical monetary policies. To address this concern, the paper has surveyed both theoretical and empirical literature on the subject matter. In addition it has benefited from member central bank feed through a structured questionnaire that was circulated among member countries.

1.3 Structure of the report

The rest of the report is structured as follows: in section two literature surveys is presented while section three contains information on the methodology. Section four provides information on the findings – i.e. status of SADC member countries use of counter-cyclical monetary policy and also information on the conditions that a country should have in place to successfully implement optimal counter-cyclical monetary policy actions. In section five, a process flow diagram on counter cyclical monetary policy intervention is presented and it offers concluding ideas and recommendations in section six.

II. Literature Review

The theoretical underpinning of the counter-cyclical policy approach is the new Keynesian small open economy model, which suggests that under full integration – the case where a country can borrow and lend freely in the global financial markets – the optimal policy approach is counter-cyclical while for economies that are autarky in nature, pro-cyclical policies are ideal (Yakhin, 2008). Another theoretical basis of the counter-cyclical policies is the Taylor rule and the Growth rule. These guide the monetary policy stance based on the deviations of inflation from its set target in both cases plus the deviation of the level of output from its long run trend, the case of the Taylor rule and the deviation of real GDP growth rate from its average growth rate, the case of the Growth rule (Bili, 2011).

An economy fluctuates around its potential output, resulting into output gaps. Potential output, also referred to as potential GDP, is the given economy's level of output that is produced efficiently and not its ever maximum level of output. In other words potential output is the level of output the economy produces when its resources are employed fully. In this regard, both smaller and bigger economies have their own potential GDPs bounded by resource availability or mobilised. Potential output is determined by supply-side factors, such as the supply of labour and machinery and their productivity.

Managing the economy above its potential GDP is an act of inefficiency. This is because the resources available are being over-utilised and may lead to a rapid wear
and tear in case of machineries and unwarranted stress in case of labour. Equally, managing the economy below potential GDP is inefficient because there are some resources that are not employed. Although it is efficient to run the economy at potential, in real life this is not the case as the resources may be over (under)utilized causing a positive output gap (negative output gap), leading to inflationary (deflationary) pressures. As Bili (2010) stated, a positive output gap construes an overheating economy and upward pressure on inflation. By contrast, a negative output gap implies a sagging economy and downward pressure on inflation. In a more realistic behaviour, the economy during a boom rises above its productive potential and the output gap is positive. In a recession, the economy falls below its productive potential and the output gap is negative.

Other than focusing on inflation within the framework of the output gap, monetary authorities can aim at stabilizing prices in the context of real economic growth, in which case, real GDP growth is stabilized around its average real GDP growth rate.

Another factor on growth stabilization monetary policy design is that if potential output follows a deterministic trend, then the change in the output gap is taken to be the growth rate of real output relative to its trend. In that regard, output growth relative to its trend is considered the ideal variable monetary policy should aim at stabilising. Under the growth focus, the central bank can aim at stabilising output such that the Government’s targeted GDP growth rate for a given period is achieved alongside the inflation target.

Related to the GDP growth stabilisation monetary policy is the nominal income stabilisation monetary policy popularised by Jensen (1999) and McCallum and Nelson (2000). The argument is that if stabilising output growth improves macroeconomic performance then there is need for the central bank to focus on stabilising nominal income. This is because nominal income growth depends on real output growth.

Given the possible approaches stated above, monetary policy actions that are counter-cyclical are such that a positive output gap (or growth rate above trend or target) requires policymakers to moderate the economy through tight monetary policy (raising the policy rate), while a negative output gap (or growth rate below trend or target) requires monetary stimulus (lowering the policy rate).

There are a number of empirical studies on the nature of cyclicality of monetary policy in developing countries. These include Coulibaly (2012) and Du-Plessis et al. (2007), Takáts (2012), Yakhin (2008), Kaminsky et al. (2004), Calderon et al. (2003) as well as Lane (2003). But there are few studies on factors that hinder or promote counter-cyclical monetary policy among developing countries and these include Coulibaly (2012), Calderon et al. (2003) and Lane (2003).

**III. Methodology**

The research reviewed empirical literature on the subject matter to establish the conditions necessary for a country to implement optimal counter cyclical monetary policy interventions. This was in addition to using a questionnaire (attached as Appendix II) that was circulated to some member countries aimed at gathering information for the purpose of establishing whether each member country pursues
counter cyclical monetary policy intervention. And if not, to find out how ready some member countries are with regard to undertaking optimal counter cyclical monetary policy interventions. The questionnaire was circulated to all member countries.

IV. The Results

4.1 Introduction

In this section we present our findings based on the literature review and a feedback from the questionnaire that was circulated among member central banks.


To appreciate the appropriateness of using counter-cyclical monetary policy it is important to highlight the conditionalities that permit employing an optimal counter-cyclical monetary policy. From the literature surveyed, a number of conditionalities have been identified that have helped developing countries to successfully implement counter-cyclical monetary policies following Coulibaly (2012), Lane (2003) and Calderon et al. (2003), which includes: Policy credibility; Robust domestic institutional infrastructure; Strong macroeconomic fundamentals; and the need for a robust macro-prudential framework.

i. **Policy Credibility:** Calderon et al. (2003) in their empirical work on some EMEs found that countries with higher policy credibility, as reflected by lower country risk levels, are able to conduct countercyclical monetary and fiscal policies unlike the ones with poor policy credibility (i.e. those with higher country risk spreads) and are likely to contribute to larger cyclical fluctuations by applying pro-cyclical policies.

This view is somehow consistent with Lane (2003) who observed that when the monetary authorities lack credibility, an action to, for instance, loosen monetary policy temporarily is perceived as indicating a persistent switch to a loose money regime. The resultant market behaviour is one that is adverse as there is an accompanied increase in risk premiums demanded by foreign investors.

Other policy credibility related factors such as trade openness and exchange rate regime have been found relevant to conducting optimal counter-cyclical policies. Coulibaly (2012) found that countries with highly open capital accounts are more likely to loosen monetary policy during crises and those countries that are most closed to trade are less likely to loosen monetary policy under similar circumstances. Further, countries with the most flexible form of exchange rate regime are more likely to loosen monetary policy when a crisis hits.

ii. **Robust Domestic Institutional Infrastructure:** Lane (2003) advises that embedding policy decisions in a formal institutional framework is very helpful in reducing uncertainty about medium-term economic prospects and consequently contribute to reducing the risk of policy-induced volatility. A robust domestic
institutional infrastructure involves a good measure of monetary policy instrument independence, a credible transparent framework for guiding interest rate decisions, a good financial market\(^2\), robust modeling and forecasting infrastructure and GDP data that is on higher frequency (quarterly). An inflation targeting regime meets these conditionalities and such regimes have been found to conduct successful counter-cyclical monetary policy. According to Coulibaly (2012), this is even true among the emerging market economies.

In addition to having an independent central bank, Lane (2003) advises that there is need to put in place a fiscal authority with some measure of independence such as a Fiscal Policy Council (FPC). The beauty of having an FPC is that it will generally conduct fiscal policy under a statutory approved medium-term expenditure framework as this is desirable in order to insulate the economy from the pressures that generate pro-cyclical fiscal policy by the Government wanting to win support from the populace. The independent FPC’s conduct of fiscal policy can augment monetary policy interventions especially in those jurisdictions with limited monetary policy instruments.

However, it should be pointed out that FPCs can only be effective if there is sufficient fiscal buffer for a given country. During the global financial crisis many governments committed huge sums of public funds in order to forestall the collapse of financial system as a way of augmenting monetary policy efforts. Fiscal buffers are necessary when an economy is facing exceptional challenges in that during the time of extraordinary economic circumstances, established economic relationships tend to fail to function as established by empirical findings.

In the absence of the FPC countries have to use Medium Tem Expenditure Frameworks (MTEFs) with a strong coordination between the fiscal and monetary authorities that can help the latter to augment monetary policy actions. Fiscal authorities under this arrangement should have no room for fiscal slippage as this can counter the optimal counter-cyclical monetary policy with a risk of causing further output and price volatility in an economy.

iii. **Strong Macroeconomic Fundamentals:** Coulibaly (2012) found that countries with strong macroeconomic fundamentals and reduced vulnerability have high chances of conducting countercyclical monetary policy. Countries with low inflation before a shock are more likely to implement a counter-cyclical monetary policy than when inflation is high. Likewise, countries with the largest amount of foreign exchange reserves are more likely to conduct countercyclical

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\(^2\) Coulibaly (2012) observes that “…Financial development enables a more efficient transmission of monetary policy and, hence, increases the incentives to conduct countercyclical policy. Also, the development of financial markets has traditionally promoted more borrowing on domestic markets and in local currencies. A higher share of local currency debt reduces risks of capital flight, and risks of currency and maturity mismatches. As such, development of domestic financial markets facilitates the conduct of countercyclical policy…”

Devereux and Lane (2003) support the importance of financial development in leveraging countercyclical monetary policy. They argue that a higher share of local currency debt, an indication of development of domestic financial markets, reduces risks of capital flight and risks of currency and maturity mismatches and in turn facilitates the conduct of countercyclical policy.
policy. And those countries with the highest levels of short-term external debt to foreign exchange reserves ratio are less likely to conduct countercyclical policies during crises.

The issue of policy credibility with regard to Southern Africa Development Community (SADC) countries is consistent with the spirit of managing the economies in line with the set macroeconomic convergence criteria (MEC) targets.

iv. **Robust Macro-prudential Framework:** It should be stated as a matter of caution that conditional on specific economic shocks; countercyclical monetary policy might not be optimal. Consider a case where a given country’s non-bank financial institutions and corporates have on their balance sheets a relatively high portion of short term debt denominated in foreign currency and an adverse shock hits such an economy. If the optimal monetary policy, i.e. a countercyclical one, is to ensure depreciation of the exchange rate then the likely outcome of such a policy intervention will be an adverse balance sheet for the corporates that have such short term debt on their balance sheets. This will negatively impact on corporate performance and consequently the real economy. However, the outcome would be less adverse or none if pro-cyclical monetary policy was undertaken.

This situation dictates that counter-cyclical approaches should be considered in light of the financial stability outlook of a given country. In this regard, countries that are going to be successful with their counter-cyclical policy actions should have a well-functioning macro-prudential framework which will act as a feedback mechanism through financial stability analyses. Financial stability analysis has helped many countries to understand and appreciate the linkages of various sectors of the economy and how imbalances in one sector can affect others. Further, the financial stability analysis has contributed to the effective and efficient resolution of problems that undermines financial stability in the countries this framework has been fully implemented.

Financial stability cannot be achieved without a robust macro-prudential research. Macro-prudential research focuses on the development of macro-financial models linking financial (in)stability and the performance of the economy. It also focuses on modelling bank defaults, something critical to financial stability. Researching on business cycles and their attendant problems of debt and leverage ratios of financial intermediaries and their variation over the business cycle is another area focused on by macro-prudential research.

Other areas of macro-prudential research relate to examination of the effects of monetary and macro-prudential policies that lean against boom-bust cycles in credit and it also examines the variables to be included in estimated models in order to improve forecasting ability. In addition, macro-prudential research analyses the behaviour of the interbank market and other matters that relate to market micro structure and how they impact on asset price dynamics.

Notwithstanding the above, counter-cyclical monetary policy cannot be relied upon solely in the event of an economic downturn. Counter-cyclical fiscal policy is more
needed as counter-cyclical monetary policy will largely come in when fiscal space is constrained and inflation expectations are well anchored. When inflation is relatively high and/or inflation expectations are not well anchored counter-cyclical monetary policy interventions are not optimal and may result in the volatility of output and prices. In this regard, counter-cyclical fiscal policy will be more optimal.

**4.3 Status of some SADC Member Countries’ Use of Counter Cyclical Policies**

In this section we present information on the status of counter cyclical monetary policy interventions by member countries based on a feedback from the questionnaire that was circulated. Responses\(^3\) were received from Angola, Botswana, Mauritius, Namibia, South Africa, Tanzania, Zambia and Zimbabwe.

Out of the eight respondents six indicated that their respective countries are pursuing counter cyclical policies in one way or the other. Four respondents stated that their countries are pursuing both counter cyclical fiscal and monetary policies while one each stated that their country exclusively pursue counter cyclical fiscal and monetary policy, respectively. More results from the survey are presented and follow the themes listed below:

a) *Policy Credibility:* From a central bank survey conducted, five respondents out of eight indicated that central bank and fiscal authorities’ decisions in their respective countries are respected by economic agents. It should be noted that accelerating full operationalisation of the SADC MEC Peer Review Mechanism (PRM) is of vital necessity to promoting policy credibility among member countries.

b) *Robust Domestic Institutional Infrastructure:* On this subject, our survey indicates that largely only one country meets this conditionality in totality and a further three meet most of them. This implies that the other four are far from meeting the basic requirements for conducting optimal counter cyclical monetary policies. However, the results – with regard to individual standards/requirements – shows that a total of seven central banks indicated instrument independence in their conduct of monetary policy and with only two indicating that they have a transparent framework for making monetary policy decisions. Further, four central banks indicated that they have well-functioning financial markets that can support government borrowing for fiscal stimulus without straining availability of credit to the private sector. Nonetheless, only two of these four indicated an availability of a secondary market for government securities.

On the issue of the availability of high frequency GDP data, four respondents indicated having GDP data on high frequency with two of them having a relatively shorter data span. Further, four respondents indicated having proxy variables that are used to gauge economic activities and thus track quarterly GDP.

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\(^3\) Two central banks belonging to the Common Monetary Area (CMA) did not respond to the questionnaire. Probably (perhaps most likely) the CMA membership will pose some constraints to their implementation of optimal counter cyclical monetary policy interventions in their respective economies. Such countries will rely more on counter cyclical fiscal policy.
In terms of central banks having economic models used for forecasting inflation and output, all the eight respondents indicated the availability of models for such purposes. All the eight countries forecast inflation with such models but only four are able to forecast both inflation and output. Further, four countries have their models with a good forecasting record while the other four indicated that the performance of their forecasting models is mixed as they are characterised by low and high forecasting errors and thus shows some inconsistencies. In a related area, central banks response to the question of a study on monetary transmission mechanism being undertaken at their Banks drew mixed responses. Two respondents indicated lack of a study on the monetary transmission mechanism on their country with the rest indicating availability of a study on the subject matter. Among the six respondents, two indicated that the study was done by experts outside the central bank with a further two intimating that studies were done by central bank staff and another two respondents stated that both external and central bank experts did separate research works on the subject matter.

Since counter cyclical monetary policy interventions largely rely on the use of interest rates as a nominal anchor, a question on which nominal anchor is used for the conduct of monetary policy among the countries surveyed drew five responses that specified the use of interest rate as a nominal anchor. Only one response indicated a none availability of a nominal anchor\(^4\) in their country while a further two respondents indicated as being monetary aggregate and exchange rate\(^5\) targeters, respectively. The five countries indicating being interest rate targeters also intimated that markets in their jurisdictions are responsive to policy interest rates adjustments as they have observed changes to credit interest rates each time there is a policy rate adjustment.

Finally on the survey findings on institutional framework, five respondents each showed a general lack of fiscal discipline in their countries on the question of prudent fiscal policy and effective coordination between the fiscal and monetary operations. They further indicated that many authorities are inclined to making expenditures that are typical of a time inconsistent problem. Further, five respondents intimated that they are often taken by “surprise” with government expenditures despite the two authorities meetings to discuss net government expenditures during a given a period. As a result, respondents regretted that “surprise” government liquidity injections tend to make monetary operations expensive and ineffective at times. This situation shows that in most member countries fiscal-monetary authorities’ coordination is not very effective otherwise surprises would have not been rife. Alternatively what this means that there are no effective institutional framework that should hold accountable parties that fail to discharge their duties prudently between the fiscal and monetary authorities. Related to the matter of institutional oversight on fiscal operations, five respondents indicated the availability of such an institution (mostly parliament and auditor general’s office) but regretted that they do not impose penalties for failure to meet the benchmarks.

\(^4\) This is by virtue of the concerned country not having a privilege of issuing its own currency

\(^5\) The concerned country belongs to the CMA
c) *Macroeconomic stability* is one of the conditionalities required to implement optimal counter cyclical policy interventions. From the survey, five respondents indicated their countries have had stable inflation in the last five years with only three respondents admitting that their exchange rate has been relatively stable over the same period. In addition, seven respondents indicated that they have sufficient reserves to deal with a sudden stop-reversal phenomenon of foreign capital flows. Further, four respondents indicated their countries having a sustainable fiscal deficit. Furthermore, four respondents indicated that their countries have fiscal buffers in place.

A look at the data submitted for Recent Economic Developments (RED) to the CCBG secretariat has revealed that a number of member countries have been running budget deficits that are not consistent with the regional MEC target for the last three years save for Angola, Seychelles and Zimbabwe\(^6\) (see Table 1, Appendix I). Prior to 2009, the period the global financial crisis hit many member countries, only Angola, Botswana and Seychelles had budget surpluses. This is one indication of the lack of availability of fiscal buffers in most member countries. The global financial crisis (GFC) highlighted the need to have fiscal buffers in place. A budget surplus or running a minimal deficit can help a country build fiscal buffers, a situation that must have largely helped Lesotho to minimise the impact of the global financial crisis shock on the country as the nation most likely used its buffer to cushion the impact of the global financial crisis. As indicated in Table 1 the country moved from a budget surplus of 4.7% of GDP to a minimal deficit of 1.5% of GDP given the decline in the Southern African Customs Union (SACU) revenues the SACU member countries endured. If the country was not running a budget surplus prior, the consequences of the GFC on the real economy was going to be even larger.

The situation of poor/lack of fiscal buffers places many SADC member countries to facing challenges in effecting counter-cyclical monetary policies when business cycles dictates so given their current fiscal positions. Without borrowing externally, the countries may lack the resources to help augment counter-cyclical monetary policy in dealing with the risks that are on the horizon or have materialized at a given time.

Further, an assessment of member country’s performance with regard to the some key variables using the RED data shows that inflation and reserve accumulation performance has not been very satisfactory (see Table 2, Appendix I). This is despite the majority of respondents indicating to the contrary in our survey. This situation is not very favourable to implementing counter-cyclical monetary policy by most member countries. More effort need to be done to ensure member countries meet the SADC MEC targets as this initiative is not only good for regional integration but also for helping countries undertake credible monetary policy actions that will help respective economies deliver on the macroeconomic stability needed to spur investment, job creation and poverty reduction. Accelerating the operationalisation of the SADC MEC

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\(^6\) Zimbabwe runs a cash budget, meaning the country only spends what it has generated.
Peer Review Mechanism (PRM) is of vital necessity in supporting attainment of macroeconomic stability within the trading block.

V. Process for Counter Cyclical Monetary Policy Interventions

Given the information above, counter policy intervention starts with putting in place the necessary infrastructure and conditionalities. The diagram below shows the steps involved in undertaking counter cyclical monetary policy interventions with forecasting being at the core since this approach is forward looking or pre-emptive in nature.

**Figure 1: Flow Diagram for Counter Cyclical Monetary Policy Interventions**

1. **Infrastructure**
   - Econometric models
   - Understanding of monetary transmission mechanism
   - Fiscal rules and fiscal buffers
   - Monetary policy instruments and adequate foreign exchange reserves (at least 6 months IC)
   - Macro-prudential framework
     - Liquidity support
     - Financial and real sector risk resolution
   - Financial Markets
     - Bond market
     - Money market
     - Sufficient liquidity

2. **Forecasting**
   - GDP
   - Inflation
   - Other key macro variables
   - Estimating the output gap

3. **Decision Making**
   - Adjustments of the nominal anchor (NA)
     - Price based NA or
     - Quantity based NA

4. **Policy Implementation**
   - Open market operations
   - Foreign exchange transactions

5. **Monitoring and Evaluation**
   - GDP and other economic indicators
   - Inflation
     - Prices
     - Costs

**Note:**
1. Under decision making (3), adjustments to the nominal anchor – Price based (interest rates or exchange rate) and quantity based (monetary aggregates) – should be done if the forecasts show inflation to be deviating from the set target and when the output gap is enlarging.

2. Under monitoring and evaluation (5), if the forecasting errors are relatively low following a regular monitoring process then the models will have to be updated and new forecasts made to influence decision making. However, if the forecasting errors are relatively high an evaluation has to be done in order to check the relevance of models describing the economy that are used in forecasts. An evaluation should also be done occasionally in order to assess a long term impact of policy actions and the efficacy of the monetary policy framework.

**Source:** Author
VI. Conclusion and Recommendations

5.1 Conclusion

Optimal counter-cyclical monetary policy is best undertaken when the monetary authorities have a good understanding of their respective economies’ transmission mechanism and with an appreciably well-functioning financial market. An institutional framework and infrastructure similar to the one required to undertake inflation targeting will help monetary authorities to conduct monetary policy that focuses on stabilising both prices and output volatility (i.e. counter-cyclical monetary policy). The framework will guide the authorities when such a policy is required to be undertaken without suffering policy regrets. However, it is important to note that monetary policy actions have limits in their effectiveness especially in the environment where interest rates have become too low and inflation expectations are not well anchored. It is therefore cardinal to note that counter-cyclical monetary interventions have to largely be supported by counter-cyclical fiscal interventions, which in turn requires the country to have sufficient resources in the treasury. In addition, for those countries that are small open economies it is generally advisable for them to adopt counter-cyclical approaches to economic management. This will help with the timely and effective handling of global impulses that can adversely affect their respective economies from the output gap perspective. Equally, the integration of monetary policy and macro prudential policies is important.

The critical factor in implementing successful counter-cyclical monetary policy actions is policy credibility. This is the cornerstone to the implementation of optimal counter-cyclical monetary policies as this virtue makes the market players to understand and appreciate the intentions of the monetary authorities. This will also help investors to price risk appropriately and thereby leading to the economy slide back to or be maintained at its steady state, depending on the situation obtaining at a particular time.

From the SADC member countries perspective, only one country\(^7\) has the necessary infrastructure and meets the conditionalities required to implement optimal counter-cyclical policies. This is despite five countries indicating that their monetary policies are largely counter-cyclical. The said country actually confirmed in the survey conducted of undertaking both monetary and fiscal policies that are generally counter-cyclical in nature. Two other countries among those surveyed showed signs of being capable of implementing optimal counter-cyclical policies given the level of domestic institutional infrastructure available in their jurisdictions. However, the other five (including the three that claims to be pursuing counter-cyclical policies) have some work to do to bring their national capabilities to undertake optimal counter-cyclical monetary policies and if they desire to do so then the recommendations listed in the next section will help to leverage their capabilities.

5.2 Recommendations

In view of the foregoing, our recommendations to the countries keen on implementing counter cyclical monetary policy measures are as follows:

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\(^7\) This is a known official inflation targeting regime.
i. Member countries should strive to achieve and maintain strong macroeconomic fundamentals, particularly achieving low inflation, accumulating a relatively high level of foreign exchange reserves, attaining a relatively high ratio of foreign exchange reserves to short-term external debt. Achieving the SADC macroeconomic convergence (MEC) targets is the right way to placing SADC member countries on the platform that will enable them undertake counter-cyclical monetary policies. It is important that initiatives to strengthen the capacity to achieve MEC targets by member countries are pursued. This includes member countries taking initiatives to mainstream MEC targets in their national programmes for fiscal and macroeconomic management. This will help with the prudent macroeconomic management through the use of counter-cyclical policies and thereby sustain macroeconomic gains among SADC countries;

ii. Member countries that are lacking fiscal buffers should create a fund for accumulating resources in good times that can be called upon to stimulate the economy in time of distress. This is because of the ineffectiveness of monetary policy when interest rates are very low or inflation expectations are not well anchored;

iii. Member countries should continue with the efforts to develop their local financial markets particularly the capital markets. This is helpful in facilitating the mobilization of resources to finance large deficits when local credit markets are constrained. Governments should look to the capital market to raise funds to finance huge deficits needed to support the economy when it is faced with difficulties in the event when revenues are falling and cutting back government expenditure can result in the economy taking long to recover;

iv. Related to the recommendation in (iii), efforts to develop the secondary market for government bonds should be enhanced in member countries so as to enhance the liquidity of local sovereign issues. This will in turn allow many investors get attracted to the government issues market and thereby help governments to quickly raise the funding necessary for counter-cyclical policy interventions;

v. The CCBG should create a framework for member countries to put in place a robust macro-prudential framework. This will help the authorities in their respective member countries get the appropriate feedback on the workings of the various sectors of the economy through the financial stability analyses. This in turn, will help to decipher the appropriate policy actions between counter and pro-cyclical needed at a particular point in time to achieve the desired macroeconomic outcomes that can be sustained for an appreciable length of time. This is because some situations in the economy may require the use of pro-cyclical actions so as to eliminate some undesirable imbalances building in the economy;

vi. The decision to operationalize the SADC Macroeconomic Convergence Peer Review Panel (PRP) is timely. The PRP should, in addition to its mandate, be used as a mechanism to help member countries pursue policies that are not
time inconsistent. It must be emphasized that the issues discussed above hinges on policy credibility. Policy credibility is the cornerstone to the implementation of optimal counter-cyclical monetary and fiscal policies as this virtue makes the market players to understand and appreciate the intentions of the monetary and fiscal authorities. Consequently, this will help to price risk appropriately and thereby leading to the economy getting back to or maintained at its steady state and;

vii. Related to the issue of avoiding problems of time inconsistency, SADC – through an appropriate organ – develop a mechanism through which member countries’ institutions responsible for preparing and managing central government budgets (Fiscal Offices) are transformed into independent Fiscal Policy Councils. Alternatively, member countries should use medium term expenditure frameworks under the oversight of SADC PRP and local budget oversight institutions. This is to ensure that member countries MTEF operations have no room for fiscal slippage.

VII. References


VIII. Appendices

Appendix 1: Tables

Table 1: SADC Member countries Budget Balance (% of GDP), 2008 - 2012

<table>
<thead>
<tr>
<th>Country/Year</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
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<td>5.3</td>
<td>10.3</td>
<td>7.7</td>
<td>-3.4</td>
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<td>0.7</td>
<td>0.6</td>
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<tr>
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<td>-1.1</td>
<td>1.0</td>
<td>0.3</td>
</tr>
<tr>
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Source: SADC Recent Economic Developments Reports, 2012 and 2013

Key: Green implies the country met the SADC target while red indicates failure to meet the target

Table 2: Selected Macroeconomic Indicators for SADC countries, 2009 - 2012

<table>
<thead>
<tr>
<th>Country</th>
<th>Inflation (Period Average)</th>
<th>Public debt as percentage of GDP</th>
<th>Months of Import Cover</th>
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Convergence criteria (2009-2012)

- 3% inflation rate by 2018
- Less than 60% of GDP by 2018
- Not less than 6 months by 2018

Source: SADC Recent Economic Developments Report, 2012
Appendix II: Questionnaire

Bank of Zambia

Questionnaire: Counter Cyclical Interventions (Do not indicate name of your country)

Dear colleague(s), kindly complete this questionnaire and return it soonest (before end of programme)

1. At what frequency is your GDP measured in your country?
   a) Annual □ b) Quarterly □

2. Does your country use indicators (lead or lag or both) that track economic activity and used as proxy for GDP
   a) Yes □ b) No □

3. If your answer in (2) is yes, how well do these indicators match the actual GDP outturn? What are they?
   Briefly explain ......................................................................................................................................................
   .............................................................................................................................................................................
   .............................................................................................................................................................................

4. Does your central bank have models that are used to forecast both inflation and output?
   a) No □
   b) Yes but only one of the two □, kindly indicate which one.........................
   c) Yes for Both □

5. If your answer is yes to question (4) kindly rate the forecasting performance of such model(s) as per guideline below
   a) have consistently large forecast errors □
   b) have consistently low forecast errors □
   c) varies (at times low and sometimes high) □

6. Is there a recent (five years or less old) study done on monetary transmission mechanism on your country?
   a) No □
b) Yes, by the scholars outside the central bank

c) Yes, by central bank experts

d) Yes, by both

7. What is the nominal anchor for your central bank’s monetary policy operations? Kindly indicate and explain briefly how it operates ……………………………………………………………………….. ………………………………………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………

8. Does your central bank enjoy operational independence? Briefly explain ………………………………………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………

9. Do various segments of financial market react to your central bank decisions with regard to asset price adjustment based on the nominal anchor indicated above? Kindly explain your answer briefly………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………

10. Do economic agents trust the decisions of your monetary and fiscal authorities in your country? Briefly explain ……………………………………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………

11. If there was a sudden stop of foreign portfolio inflows (equity, sovereign debt and bank credit) and there is sudden reverse in their flows, can your country’s current level of foreign reserves be adequate to prevent a foreign exchange crisis? Briefly explain the basis of your answer ……………………………………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………………

12. Which macroeconomic indicators in your country have enjoyed some appreciable level of stability in the last four years? ………………………………………………………………………………………………………………………………………………… ………………………………………………………………………………………………………………………………………………………

13. Does your country have prudent fiscal operations? Briefly explain your answer ……………… ………………………………………………………………………………………………………………………………………………………

17
14. Are institutions (if any) that provide budget oversight in your country effective to hold government accountable in the way it executes its budget? .................................................................
........................................................................................................................................................................

15. Do fiscal authorities in your country have sinking fund set up for use in future or time of crisis?
   a) Yes □    b) No □

16. Can your country raise huge amounts of money in your domestic market at short notice without causing a shortage of funds for the private sector?
   a) Yes □    b) No □

17. Is there a vibrant secondary market for government securities in your country?
   a) Yes □    b) No □

18. Does your central bank anticipate government net expenditure decisions in a given period or is it the case where the central bank is taken by surprise? Briefly explain your answer
   ..............
   ................................................................................................................................................................................

19. Does your country pursue counter cyclical polices either monetary or fiscal or both
   a) No □    b) Yes, Fiscal □ c) Yes, Monetary □ d) Yes, Both □

20. If the answer to your question (19) is No, kindly indicate areas in which your country need to improve in order to be able to implement counter cyclical monetary policies
   ................................................................................................................................................................................
   ................................................................................................................................................................................
   ................................................................................................................................................................................

End, and Thank You For Your Responses