



# Advocacy on Monetary Policies for Economic Justice

A HANDBOOK FOR CIVIL SOCIETY

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## — Origins of the handbook

This handbook was drafted collaboratively by the following organizations: ActionAid International, Eurodad, INESC (Brazil), SEATINI and CEHURD (Uganda), SIKKA (Tanzania), and WEMOS. This group came together to explore how greater civil society engagement in the monetary policy arena can increase domestic resource mobilization.

The handbook is the outcome of this collaborative process, and does not necessarily reflect any one organization's opinion; rather, it aims to advance work on this topic, and to start a discussion in this area among civil society. This is because we collectively recognize the need for civil society to engage in monetary policy to help achieve economic and social justice. We also recognize this is important for meeting the wider aims—to tackle poverty and social exclusion, to ensure universal access to quality and equitable public services, and, to reduce inequality—of our own organizations.

## — Why this handbook is necessary

This handbook aims to facilitate further exploration by civil society in the realm of monetary policy; typically organizations explore fiscal policy options, but very few explore monetary policies, or the linkages between monetary and fiscal policies. In part, this is because monetary policies have been relegated to a purely technical issue, rather than a political one. But this also reflects a lack of awareness of alternatives to the main neoliberal economic models.

Indeed, the neoliberal economic model that has swept across the world since the 1980s dramatically changed the global economic system, and led to a shrinking role for government in regulating the economy, and more regressive economic policies. Embedded within this was a different vision of the role that monetary policies and central banks play in the economy. Not only did this vision alter the role they play, but it also relegated this to technical decision-making roles—to be made by technocrats, mostly sitting in Central Banks—rather than placing monetary policies into the political sphere and opening up engagement by citizens.

This handbook aims to highlight that this vision is just one expression of the role of monetary policies. Monetary policies are crucial in determining government budgets and fiscal space for essential services; as such, monetary policies are not driven by merely technical considerations but also involve political choices. This means that civil society organizations who care about fiscal and economic justice need to better understand their role; yet, currently, civil society rarely, if at all, engages in monetary policies and with central banks. This handbook aims to help to begin to change this.

In the handbook we explain how monetary policies (along with fiscal policies) play an enormous role in mobilizing domestic resources to finance public services and for meeting the Sustainable Development Goals. We argue that in order to address global issues, finance public services and fight inequality, governments and development institutions should consider a different role for monetary policies. The central aim of this handbook is to provide a simple, easy-to-read guide for civil society organizations to understand monetary policies, why they should care about them, and to urge civil society to start engaging with this topic if they want to drive change.

## — Why this matters (now more than ever)

This handbook was conceived and written at the height of the Covid-19 pandemic in 2021, during which the global economy was under a lot of stress and low- and -middle income countries were facing growing spending needs. Unlike high-income countries, most low- and -middle income countries had limited fiscal space and many had to resort to borrowing from the IMF to sustain the expenditure needed to face the Covid-19 emergency. As debt levels exploded, the alarm was raised for a new wave of contractionary fiscal policies.<sup>1</sup> At the same time, inflationary pressure started to mount in rich and poor countries alike and the prospect of monetary tightening by the US Federal Reserve and the European Central Bank (ECB) became more concrete. The risk that many low- and -middle income countries would have to follow suit, as well as face raising borrowing costs on international financial markets was evident.

In this context, it seemed important to equip civil society organizations with a better understanding of monetary policy and its interaction with fiscal policy to help them defend public spending in the difficult years of austerity ahead.

As this handbook was finalized, Russia invaded Ukraine, and the global economy fell into a new, dramatic crisis, triggering a sharp rise in food and energy prices—straining the fiscal and external balances of commodity-importing countries and increasing food-security concerns across many low- and -middle income countries. According to estimates from the World Bank, an additional 75–95 million people will be pushed into extreme poverty in 2022.<sup>2</sup> The risk of a wave of debt crisis across poor and emerging economies is more concrete than ever, as interest rates have started to increase to cool inflation. UNCTAD has warned that the combination of weakening global demand, insufficient policy coordination at the international level and elevated debt levels from the pandemic can push some low- and -middle income countries into a downward spiral of insolvency, recession and arrested development.<sup>3</sup>

Even without such a dramatic spiral, many low- and -middle income countries are going to face limited fiscal and policy space and difficult economic policy choices. It is more important than ever that civil society is ready to scrutinize, assess and influence these choices to ensure they do not lead to severe cuts in public spending that would hurt the poorest people the most, deepen inequality and further delay achieving the Sustainable Development Goals (SDGs).

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## — Introducing the Handbook

### **Monetary policies: should they be outside the political debate?**

In 2015, the internationally agreed Sustainable Development Goals (SDGs) and the consensus document from the United Nations' Financing for Development conference in Addis Ababa both called for greater country ownership and sustainable financing for development. While foreign aid remains important, countries must increase their domestic resource mobilization in order to achieve the SDG goals. There are several important ways low- and middle-income countries can increase their domestic resources, such as: curtailing tax evasion and tax avoidance; eliminating illicit financial flows; increasing tax revenues; investing in productive sectors; and, expanding social security coverage and associated contributory revenues.

Monetary policies play a crucial role in mobilizing domestic resources. However, such policies are often not part of the political debate, because they are viewed as a merely technical issue and therefore entrusted to technocrats, mostly sitting in Central Banks, rather than politicians—unlike fiscal policies, which touch upon more explicitly politically sensitive issues such as wealth redistribution or allocation of public expenditure. As such, although monetary policies play a central role and heavily influence many aspects of the economy, they often remain outside of political and public debate.

Yet, the history of economics also shows that monetary policies are not just a technical issue and can be carried out in different ways, according to different economic models. This means that different objectives driving monetary policies have a crucial influence on countries' fiscal space and domestic resources.

Certainly, to finance public services, and to achieve the ambitions contained in the SDGs, we must challenge the way monetary policies are carried out and their relationship with fiscal policies. For example, a joint publication in 2017 by the ILO, UNICEF, and UN Women<sup>4</sup> pointed out that countries can mobilize more domestic resources through a more accommodating macroeconomic framework, involving both fiscal policies and monetary policy choices.

The Covid-19 pandemic has reopened the much-needed dialogue for considering alternative monetary approaches. The Covid-19 crisis exposed failures in current economic models, with the poorest and most vulnerable—including women and those facing intersecting inequalities—hit hardest. At the same time, almost overnight, new policies to safeguard public health in countries shut down economic activities to control the spread of infection. Governments had to quickly mobilize resources to face the pandemic, not only to finance public healthcare but also to support the loss of economic activity. This situation forced governments and central banks to work together to achieve that. For example, the European Central Bank initiated the European Pandemic Purchase Program, through which it financed European governments' expenditures to face the crisis.<sup>5</sup> Similarly, the United States initiated a US\$1.9 trillion COVID relief plan, which is largely financed through monetary policies adopted by the Federal Reserve.<sup>6</sup> This was made possible only by breaking with the current day conventions of economic policy, of maintaining artificially low interest rates, and by financing the fiscal deficit of the governments by releasing liquidity from central banks.

Countries in the Global South had less options to break with these rules, due to historically unequal power relations, rooted in imperialism and colonialism. For instance, while many high-income countries in the Global North used their monetary policies to finance huge injections of government expenditures, central banks in low- and middle-income countries in the Global South tend to act more independently from government oversight and had less options available. This independence from democratically elected governments has been a key recommendation of the World Bank and IMF in their country



programs since the 1980s—despite the distance this creates from societies and citizens. This leaves governments with less options in such crisis situations. Such institutions have tended to propose conservative economic approaches where monetary policies are aimed at keeping prices stable, rather than expanding the fiscal space for public services, creating jobs, and promoting equitable economic growth—laying the foundation for neoliberal policies which can stifle governments’ capacity to meet human rights obligations.

## — Aim of the handbook

Civil Society Organizations (CSOs) the world over have joined forces in demanding tax justice, including through more progressive fiscal policies, supporting measures to counter illicit financial flows and tax avoidance, and demanding global corporate income taxes. However, the critical role that monetary policies and central banks play in achieving social justice and development has often been neglected by CSOs—seen as a marginal or technical issue outside of their mandates. For many, monetary policy may seem too complex a project, or something which is best left to economists.

This handbook aims to help support CSOs to begin to engage with this topic, and understand why this is important, to help to mobilize much needed domestic resources to reach the SDGs. We aim to illustrate how monetary policies are intimately connected to income and wealth generation and distribution. Ultimately, we want to bring monetary policies into the political debate, as part of a badly needed more accommodative and progressive macroeconomic framework.

Thus, it aims to create an easy guide to understand monetary policies, and the broad linkage with domestic resource mobilization and fiscal space. The handbook also aims to show that democratic institutions may benefit from an altered mandate and stronger democratic accountability of central banks.

## — Structure of the handbook

The handbook is organized as follows:

**Part 1** is an overview of monetary policies, and the mandate and tasks of central banks and their main policy instruments. This provides an easy guide to understand the basic terminology and the mechanisms of monetary policies when engaging in debates and advocacy activities.

**Part 2** describes how monetary policies influence fiscal policies. It aims to provide an overview of concepts that are essential for readers who wish to understand how monetary policies can be used to expand fiscal space for public services.

**Part 3** describes how monetary policies interact with international trade and capital flows, exchange rates, and public debt. Such concepts are to be considered in the public debate, as they are important in restricting the use of monetary policies to expand fiscal space.

**Part 4** describes how macroeconomic policies evolved over the years, the current state of the debate, and makes the case for adopting more expansionary policies to achieve the SDGs.

**Part 5** concludes by briefly underscoring the importance of CSOs to engage in monetary policies.

# Part 1

## The basics of monetary policies

### — What is money?

Money is any item (like coins or banknotes) or verifiable record (like a bank account) that is generally accepted as payment for goods and services and repayment of debts, such as taxes, in a particular country or socio-economic context.

In every country, money takes a standardized form which is called “currency” - for example Euros, Dollars, Shillings, Yen, etc. Each currency is issued by the government and, by law, it must be accepted as a form of payment in the country where it is issued.

The value of a currency depends on its purchasing power: how many goods and services can be purchased with a unit of currency. When a general increase of prices occurs (**inflation**), the value of the currency will decrease (as people will be able to purchase less goods and services with the same amount of currency). When general prices decrease (**deflation**), the value of the currency will increase.

### — The origin of money, the Bretton Woods system and the centrality of the dollar

Originally, precious metals like gold and silver were commonly used as money. Later, to facilitate trade between countries, countries devised the “gold standard”, a monetary system where a country's currency has a value directly linked to gold.


Around the 1930s, the gold standard was abandoned, as it was deemed too rigid to respond to the needs of an ever expanding and increasingly complex global economy. Countries started to use a payment system based on Fiat money, which is a government-issued currency that is not backed by a physical commodity, such as gold or silver, but rather by the government that issued it.

However, without the gold standard, many economists and governments called for a global monetary system where global trade and finance was facilitated by a global currency. This “global currency” needed to be credible—i.e., its value should remain stable and should be backed by a physical commodity. Under these premises, the Bretton Woods system was created in 1944.

The Bretton Woods system (*see Box 1 on the role of the IMF*) established a system of payments based on the US dollar, which defined all currencies in relation to the dollar. The dollar was considered credible as it was backed by gold and in theory, each dollar could be exchanged for a fixed amount of gold. This made the U.S. currency effectively the world currency—the standard to which every other currency was pegged. However, the Bretton Woods system proved again to be much too rigid to respond to the needs of the global economy, and was abandoned in 1971.

Nowadays, international trade is conducted using a set of “hard currencies” (i.e., currencies whose value remains relatively stable over time) that are widely accepted internationally. These currencies are also used as “reserve currencies”—i.e., currencies maintained by the central banks to pay international debt obligations, transactions, and investments.





The main currency used for international trade (as well as the main reserve currency) is by far the US dollar, as the widespread use of the US dollar in international trade under the Bretton Woods system contributed to the supremacy of the United States and their power and influence over the global economy. Other important reserve currencies are the Euro, the Japanese Yen, and the British Pound.

We will talk more about the Bretton Woods System and its consequences later on in other chapters. However, for the moment, it is important to keep in mind that the US dollar is the most important currency for international trade and finance.

## — What is a central bank?

A central bank is a financial institution which has a privileged control over the production and distribution of money and credit for a nation (or a group of nations as happens in the Eurozone).

The central bank is responsible for the monetary policy of a country, and it regulates the mandate of the commercial banks. For this reason, unlike commercial banks, central banks have a **legal monopoly** on the availability of a currency, having the privilege to issue banknotes, cash and credit. Because of this supervisory role over monetary policies, central banks do not act as market institutions. Central banks have a public mandate, and their profits are typically sent to the government. However, notably since the 1980s, most central banks began to act independently from the government and were no longer a government agency—this hasn't always been this way.

## — What are monetary policies?

The expression 'monetary policies' refers to the actions undertaken by a nation's **central bank to control the money supply** and achieve sustainable economic growth. Money supply is the total amount of money in circulation or in existence in a country. Monetary policies can be broadly classified as either expansionary (when they expand the country's money supply), or contractionary (when they reduce it).

**Expansionary monetary policies**, when appropriately used, stimulate the economy. When more money is available, people can purchase more goods and services – in economic terms, we call it an 'increase of the aggregate demand'. Since people buy more, companies do well and they expand and create more jobs. This reduces unemployment and increases salaries, contributing to the overall wealth of the society.<sup>7</sup>

But expansionary monetary policies can increase inflation. When too much money is available, the aggregate demand can increase too quickly, whereas the supply of goods and services takes longer to increase. When an increase in the demand does not meet an increase in the supply, prices increase. Basically, people want to buy more, but the number of goods and services that can be sold is limited. So, the prices increase, and a sustained price increase generates inflation. An excessive level of inflation is undesirable (although which level is undesirable is not universally agreed) because it discourages investment and decreases real wages (meaning that if wages remain the same and prices increase, the purchasing power of the population diminishes, which can push people into poverty or deeper into poverty).

**Contractionary policies**, on the other hand, usually aim to curb inflation, and they often do that by slowing down the economy by raising the interest rate (see next section). Less money going around means less investment, employment and aggregate demand for goods and services, which can decrease inflation (provided that the increase in prices was caused by an excess in the aggregate demand). However, this can also increase unemployment—an obvious setback of this policy. It should be noted that this plays

out differently depending on the labor rights in place: where strong labor rights are in place, which guarantee protection of job, this has less impact, where there is deregulation and labor market flexibilization this facilitates labor lay-offs (see more on this later in Part 4).

In general, central banks aim to reach a balance, where the money supply is enough to support the demand for goods and services, but the inflation rate remains under control. For this reason, some central banks have the double mandate of 'price stability' (i.e., to maintain a relatively constant low level of inflation) and 'full employment' (i.e., to create a situation where all available labor resources are being used in the most efficient way). Other central banks have a single mandate, being only tasked with maintaining price stability. Both full employment and price stability contribute to economic growth.

To use a common analogy,<sup>8</sup> we can imagine that if countries were a farm, a central bank would be the person in charge of water and irrigation. Its job is to keep water (money) flowing enough to maximize crops (strong job creation), but also to avoid pumping in so much water that it causes flooding (uncontrolled inflation).

#### OTHER USEFUL DEFINITIONS

**Aggregate demand:** an economic measurement of the total amount of demand for all finished goods and services produced in an economy.

**Price stability:** a situation where prices are stable, due a constant low level of inflation.

**Full employment:** a situation of very low unemployment, where all available labor resources are being used in the most efficient way possible.

**Real wages:** wages adjusted to inflation.

**Liquidity:** usually refers to the amount of money an individual or corporation has on hand and the ability to quickly convert assets into cash. In macroeconomics, liquidity can also be connected to the money supply, the amount of money in circulation or in existence in a country.

## How do central banks control the money supply?

As shown above, monetary policies involve a series of actions, undertaken by central banks, to increase, or decrease, the availability of money in a country (i.e., the 'money supply'). This sounds really abstract, so it is useful to explain how central banks, in practice, can increase the money supply. In the following sections, we will outline the main ways in which central banks do that. However, the way monetary policies are regulated varies greatly depending on the country. It is thus important to specify that not all the mechanisms outlined below can be applied in every country, and that each country has its own specific ways to control the money supply.

### Controlling the discount rate (or Central Bank Rate)

The discount rate is the interest rate charged to commercial banks and other financial institutions for the loans they take from the central bank. While commercial banks can borrow and loan capital for their operations from each other, they can also borrow from the central bank. For this reason, the discount rate is the smallest interest rate that can be charged and determines the other interest rates in the economy (if the discount rate is high, the other interest rates will be the same or higher).

Controlling the discount rate is the most common way to control the money supply. A small discount rate stimulates investment, and higher rates stimulate savings. When interest rates are higher, for example, people will prefer to save money (on which they can earn a good interest), rather than borrowing (and

having to pay high interest on their loans). Commercial banks follow the same logic: higher interest rates mean less credit for people and companies and more stimulus for buying government bonds, which usually offer the discount rate.

When economic growth slows down, the central bank can reduce the discount rate, which increases the availability of capital for commercial banks. Thus, when banks make credit available at lower interest rates, people are able to borrow more money, more money is invested and used to buy goods and services, and the money supply increases.<sup>9</sup> When the economy ‘overheats’ and inflation increases too much, the central bank can increase the discount rate. This makes borrowing more expensive, hence causing people to borrow more cautiously and spend less, preventing inflation from rising.

Controlling interest rates has limits. In difficult economic situations, banks prefer to hold liquidity instead of borrowing or investing, regardless of the low interest rates. Moreover, when interest rates are already low, there is less room for the central bank to cut discount rates to stimulate the economy.

### Controlling the reserve requirement

The amount of money that commercial banks can lend to their customers is proportional to their deposits (or “reserves”). This proportion between the reserves and the lending capacity is called **cash reserve ratio or reserve requirement**. The reserve requirement varies considerably from country to country and is controlled by the central bank. For example, in April 2022, the reserve ratio was 21% in Brazil, 4% in India, 6% in Tanzania, and 0% in the US.

To increase the money supply, central banks can lower the cash reserve ratio, making it easier for commercial banks to borrow from the central banks. This allows commercial banks to increase their liquidity, and thus the credit available for formal businesses that have access to the financial market. The increased availability of capital allows banks to decrease the interest rate.

### Open market operations

Another method to control the amount of money in circulation is through open market operations. Central banks can buy and sell various financial products, such as government and commercial bonds, foreign currencies and so forth, by using the money at the central bank deposit. The money used for all these purchases or sales results in the same amount of money entering or leaving market circulation, hence influencing the money supply.

#### COUNTRY EXAMPLE 1

#### Example of the cash reserve ratio in India

In India, the cash reserve ratio is 5%. This means that banks are allowed to borrow money from the central bank for a total amount that is approximately 20 times their reserves. Therefore, when someone deposits 1000 Rupees in its bank in India, the bank is allowed to lend money to their customers for a total amount of 20,000 Rupees. If the cash reserve ratio decreases to 2.5%, for example, the bank will instead be able to borrow from the Bank of India for a total amount of 40,000 Rupees (i.e., it will double the maximum amount of money that can be injected in the economy with every deposit).

For example, if the central bank wishes to decrease interest rates (thus executing an expansionary operation), it can purchase government bonds from commercial banks, hence increasing the amount of cash in circulation (or increasing the banks' reserve accounts). Commercial banks then have more money to lend, so they reduce lending rates, making loans less expensive.

### Unconventional monetary policies

'Unconventional monetary policies' are policies that, according to the current neoliberal economic paradigm, are non-standard policies which are used in exceptional situations when conventional monetary policies are insufficient to stimulate economic growth. They are called 'unconventional' because, while they are supported by some economists, since around the 1980s, they have been viewed with skepticism by some mainstream economists (e.g. those that support neoliberal economic policies).

Until a few years ago, these 'unconventional' monetary policies were not even considered an option, but they had a resurgence after the 2007 financial crisis, when conventional monetary policies proved to be insufficient to address the scale of the crisis. The response to this included a mix of the following measures:

- ▶ **Quantitative easing (QE):** the purchase of government bonds (and some other types of assets) for a sustained period, as happens in open market operations. The biggest difference between quantitative easing and routine open market operations is that quantitative easing entails a pre-commitment from the central bank to conduct purchases to a pre-defined (large) volume and for a predefined period. The increased amount of money made available through quantitative easing lowers interest rates and stimulates investments, and the pre-commitment of central banks brings confidence to capital markets (often referred to as 'the markets'<sup>10</sup>), which are then more motivated to invest. Quantitative easing became more common after the 2008 financial crisis, when it was widely used to pull countries out of the recession. However, quantitative easing only works if there is transmission of lower interest rates and higher borrowing from the central bank to the banking system and from the banking system to the real economy. This also means that quantitative easing is not really an option for countries with smaller financial sectors where the real economy is not financialized (meaning that the investment capacity of local firms does not depend much on the availability of cheap credit from commercial banks but is dependent on other factors).
- ▶ **Forward guidance:** consists in the communication, in part by the central bank authority, of its future intentions regarding monetary policies. This helps markets to regain confidence, invest money, and, in turn, stimulates the economy.
- ▶ **Negative interest rates:** the use of negative interest rates during a financial crisis pushes commercial banks to spend and lend their cash reserves rather than storing them.
- ▶ **Direct government financing:** when a central bank directly finances the government, public spending directly translates into an increase of the money supply (see part 2 below).

## — The endogenous money supply

Central banks are not the only banks that can inject money into the economy. Financial intermediaries—such as commercial banks, investment banks, or investment funds and so forth—can also increase the total amount of money in circulation. For example, since banks can borrow much more money than they have in their deposits (see information on the reserve requirements previously in this section), they can in practice increase the amount of money in circulation. This phenomenon is called 'endogenous money supply'.

# Part 2

## The relationship between fiscal and monetary policies

**This section aims to briefly show how the broad range of monetary policy tools can be used to finance government expenditure, and thus raise domestic resources for public services and pro-poor or equity enhancing spending. It is for this reason that civil society organizations may wish to engage in this area: to increase financing for public services; to achieve the SDGs; or, to ensure the maximum available resources for achieving human rights. However, before illustrating these policy tools, we must clarify exactly what we mean by fiscal policies and how these can be used.**

### Fiscal policies

The term ‘fiscal policy’ defines the set of policies used by the government to adjust public spending and taxation. Just like monetary policies, fiscal policies can be divided between expansionary policies when they increase liquidity (i.e. when governments increase their spending and/or cut some taxes), and contractionary policies when they decrease it (i.e. when governments cut down on spending and/or increase some taxes).<sup>11</sup>

Civil society organizations aiming to increase spending often do so by calling for progressive taxation to deliver this. This is because fiscal policies can be a powerful instrument to fight poverty and inequality—when done so progressively. They can do this by calling for reforms to specific taxes (i.e. well-designed scales, exemptions or thresholds, or increases in wealth taxes) or a mix of progressive taxes with high rates for high-earners, combined with low-rated consumption taxes that bring about a more progressive overall tax system. To be genuinely progressive, this must also generate sufficient public revenue for progressive spending, so this revenue is fairly redistributed and focused on rebalancing economic and gender inequalities (i.e. through public investment in quality basic services for all, like health and education, that benefit people with lower incomes the most).<sup>12</sup> As such, tax and fiscal justice is a central concern for anyone working for social justice.

However, it is important to remember that the government budget is not limited to fiscal revenue (i.e., how much the government collects through taxes or grants). A significant part of the money that governments spend is borrowed through market operations, such as issuing government bonds. Hence, governments can spend more than they collect through revenue, simply by borrowing money. When the total expenditures of the government exceed the fiscal revenue (e.g., the money collected from taxes), the government is in a situation of ‘fiscal deficit’. Conversely, when government revenues exceed expenditures, this is called a ‘fiscal surplus’. Fiscal deficit increases the public debt, whereas fiscal surplus decreases it.

An important decision for governments is how to allocate public spending—whether to use it to increase long-term public investments, i.e., in public health, education, transportation or infrastructure aimed at increasing productivity, Gross Domestic Product (GDP) and wages, or short-term consumption. The latter is easier to do and is more likely to bring electoral pay-offs to governments in power, but it is also often wasteful and adds to the national debt without generating long-term benefits.

Low- and middle-income countries which need to finance their spending resorting to loans from the IMF (and from financial markets) are often erroneously assumed to only do the latter, and as a result are prevented from engaging in significant deficit financing generally. But, in so doing, they are also prevented from scaling up public investment, leading to under-financed public health and education systems.

In the last 40 years, the importance of progressive fiscal policies and public spending has been neglected, although things have started to change after the global financial crisis. Instead of promoting public investment for sustainable economic growth, policymakers and international financial institutions (IFIs) focused on maintaining a stable macroeconomic environment that is conducive for private investment, and private wealth accumulation, through free flows of capital. This has occurred because monetary policy targets (price stability and low inflation) were prioritized over public expenditure (with government debt being seen as the 'ultimate economic sin'), leading to a decrease in public investment and constraints on government budgets.

## BOX 1: HOW GOVERNMENTS BORROW MONEY FROM THE MARKET

**I**f governments want to raise money from the market<sup>13</sup> to finance their expenditure, they promote treasury auctions, in which they sell government bonds to investors. When investors buy bonds in these auctions they basically lend to the government an agreed amount of money (the value of the bond) for an agreed period of time (the "maturity" of the bond). In return, the government will pay back a set level of interest at regular periods.

In treasury auctions, the government issues a range of bonds with different interest rates and maturity. Of course, the government is interested in selling bonds with low interest rates and long maturities, as it will have to pay less interest on the money it borrows over longer periods of time; financial institutions instead, will be interested in buying short-maturity bonds with high interest rates, to have higher and faster returns on their investment.

The total interest on debt issued by a government depends on the demand for its bonds: if the demand is low, market participants will only want to buy bonds with high interest rates. Conversely, if the demand for government bonds is high, the government will be able to sell bonds with low interest rates, hence financing its expenditures at a lower cost.

What makes government bonds more attractive for investors? The confidence that the bond will be repaid. If investors think that a country is at risk of default, maybe because its public debt is high and unsustainable, they will be less keen to purchase their bonds. This leads the government to sell its bonds at higher interest rates, making the public debt more expensive. Moreover, central bank operations can increase the confidence of investors, leading them to buy government bonds at lower interest rates (see section on quantitative easing and forward guidance for more).

Inflation expectations also influence the interest rates on the public debt: if investors expect high inflation, they will demand higher returns on their investment, as the value of the currency itself is expected to decrease. Hence, they will be more likely to buy only bonds with relatively higher interest rates, or bonds that are automatically adjusted to inflation.



## — Monetary financing of public expenditure

Clearly, fiscal and monetary policies are very tightly related. Monetary policies can be used to provide both direct and indirect forms of monetary financing of public expenditure: by way of example, below are some of the main historical ways that governments have expanded fiscal space through monetary policies.<sup>14</sup>

### **Lowering the interest rates**

As we already said, expansionary monetary policies—such as decreasing the discount rate—lower the interest rate. This means that when the government needs to sell bonds to raise credit for public spending, it can do so at lower interest rates. Hence, governments can borrow money from ‘the market’ at lower interest rates, making it easier to finance government expenditure. On the contrary, when governments sell bonds at higher interest rates, these high rates can quickly make such higher spending unaffordable—thus constituting a constraint on fiscal policy. It is important to state, though, that there is no specific rate at which spending becomes unaffordable, and there is disagreement among economists on what this should be, and how to measure it.

### **Financial regulation**

Monetary financing can also be achieved through extra regulation of the financial sector (sometimes referred to as use of ‘financial repression’). These are monetary measures that allow governments to channel funds from the private sector in order to finance its expenditures. One such measure is the capping of the interest rates on government debt, which obliges private banks to lend money to governments at prescribed low interest rates. Another form of financial regulation consists in raising the liquid asset requirements in the form of government bonds of commercial banks. This way, the government can borrow from the domestic financial sector at below-market interest rates, as banks will be incentivized to lend money to the governments.

### **Direct forms of monetary financing**

Central banks can also purchase government bonds, hence financing the public expenditure. They can do so by purchasing government bonds from the primary market (i.e. where companies and governments sell bonds and other securities to the market) and from the secondary market (where bonds and other existing securities are exchanged between investors).

Selling government bonds directly at their release in the primary market allows governments to finance their public expenditures much more cheaply, as they do not have to pay interest to market participants (**see Box 1**).

This and other direct ways of government financing, such as direct lending, was more common before the 1980s. However, in many countries today, the direct purchase of government bonds in the primary market by the central bank is not allowed (see below section on central bank independence). However, this practice has reappeared in some emerging markets with the Covid-19 crisis, as many governments need to find a way to finance the measures needed to face the crisis.<sup>15</sup>

### **Government debt purchases on the secondary market**

Alternatively, central banks can buy already-issued government bonds in the secondary market. This practice is a less direct form of financing government expenditures. However, as the central bank buys government bonds (from commercial banks) in the secondary market, the demand for bonds rises and more liquidity is made available for commercial banks, which will then want to purchase more government bonds in the primary market.



## COUNTRY EXAMPLE 2:

### The evolution of monetary policy in Tanzania—From money supply-targeting to interest rate-targeting

After a period of hyper-inflation above 30% and falling income per capita growth rates in the early 1990s, as well as rising deficits, the Tanzanian government, under pressure from the IMF, agreed to establish a monthly cash budget system ceiling on spending by Ministries (which directly prevented monetary finance). It also set a medium-term target inflation rate of 5%.<sup>1</sup> At the same time, the central bank's increased independence was established. In so doing, the primary monetary policy objectives were established to ensure "price stability conducive to balanced and sustainable growth" as well as to promote "sound monetary, credit and banking conditions conducive to the development of the national economy".<sup>2</sup>

The Bank of Tanzania (again in collaboration with the IMF) decided to pursue a money supply-targeting framework that is consistent with the government's economic growth and inflation targets, including developing the financial market and reducing inflation by controlling the money supply.<sup>3</sup> The approach brought headline inflation down to single digits.<sup>4</sup> While the money supply-targeting framework had been effective to achieve macroeconomic stability, the approach was seen to undermine the long-run development of financial markets.<sup>5</sup> The monetary policy was further complicated by unpredictable government operations, erratic disbursements of donor grants, the government's cash management problems, and the banking systems' large precautionary reserves. This led to unforeseen injections or shortfalls in available money required to meet the money supply targets.<sup>6</sup>

To provide a more conducive environment for the development of the financial sector, the Bank of Tanzania moved in 2017 to an interest rate-targeting framework that allows the central bank to stabilize short-term interest rates. This approach helped soothe the money market and strengthened the pass-through to medium-term and long-term interest rates: when the Bank of Tanzania cut the discount rate from 6.9% in January to 2.2% in July 2017, the yield of 5-year treasury bonds also dropped from 18.0% to 13.1%. But private sector lending rates remained at elevated levels due to a rise in non-performing loans and tightened lending regulations by the central bank.

The Tanzanian example illustrates the importance of understanding how a country's state of financial market development interacts with its fiscal and monetary policies.

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[1] Kessy, Nyella, O'Connell (2017), Monetary Policy in Tanzania: Accomplishments and the Road Ahead, Economic Faculty Works, Swarthmore College.

[2] Bank of Tanzania Act (2006), section 7 on the formulation and implementation of monetary policy.

[3] The Tanzanian government was committed to a flexible exchange rate regime to avoid going through another balance of payment crises like in the 1970s.

[4] That means economic growth remained stable in Tanzania in 1997 at round 4% while it was accelerating in other countries.

[5] Compare Montiel et al. (2012), Financial Architecture and the Monetary Transmission Mechanism in Tanzania, Working Paper F-40003-TZA-1, International Growth Centre.

[6] International Monetary Fund (2016b), IMF Country Report No. 16/255, p. 4.

If a central bank has interest rate targets, it will often have to operate in the secondary market to make sure its targets will be met, counterbalancing the action of the Treasury. For example, if the government sells bonds in the primary market, to finance its spending, there will be, in the short-term, less liquidity in the market, which will push interest rates up. Thus, the central bank will be forced to buy bonds in the secondary market to increase money supply and keep the interest rate in its set target. This also means that the government will not have substantial problems in financing itself, since the central bank will indirectly finance the government in the secondary market.

Moreover, central banks can buy government bonds through unconventional monetary policies such as *Quantitative Easing*, which have a great effect on the public purse. The declared intention from the central bank to purchase government bonds for a protracted period of time will give confidence to investors, who will purchase more government bonds in the primary market, even at low interest rates. This is because investors know that they will be able to sell them to the central bank in the secondary market.

#### KEY MESSAGE

**The central bank has many tools to finance the expenditure of the government, and to decrease the cost of public debt.**

## Inflation: definition and causes

As we explained in Part 1, inflation is a general increase of prices. As price changes are explained, in the economic theory of supply and demand, the causes of inflation are identified in changes in the demand or the supply. For this reason, there are different forms of inflation:

- ▶ **Demand-pull inflation** is caused by an increase of aggregate demand. As people buy more goods and services, the prices of these increase. In many cases, demand-driven inflation is caused by expansionary fiscal and monetary policies.
- ▶ **Cost-push inflation** is caused by externalities which drive up production costs, thus lowering the aggregate supply. The oil shocks in the 1970s, or the increase in gas, oil, wheat and food prices in 2022 caused by the war in Ukraine, are examples of supply driven inflation. As economies are very reliant on fossil fuels, a price increase of gas and oil often translates into a general increase of prices, as we are currently seeing in economies around the world.
- ▶ **Imported inflation** is a specific type of cost-push inflation occurring in countries that are very reliant on imported goods. In these economies, increases of prices of imported goods can cause inflation. However, imported inflation can also be caused by expansionary policies that trigger a depreciation of the country's currency (see part 3).

## — The role of inflation targets in monetary policies

As previously explained, although expansionary policies can expand the public purse, as well as stimulate economic growth and job creation, they can also increase inflation—yet very high levels of inflation tend to be undesirable. The range of actions of monetary policies available to a country depends on the estimate of unused productive capacity ('output gap') and the level of inflation that is considered acceptable. If only low levels of inflation are accepted, the discount rate cannot go down too much, central banks cannot buy government debt, and so forth.

Central Banks argue that credible inflation targets create a conducive environment for investment. If prices are stable, the government, companies and people can make sound decisions about saving, borrowing, and investing, contributing to a well-functioning economy and society.

Excessively high inflation, on the other hand, can lead to a spiral that goes out of control: as prices increase, people will demand higher salaries to keep up with the prices and be able to meet their basic needs. This will lead companies to charge more for their goods and services, to compensate for the higher salaries, leading to more inflation. As such, inflation can reach such high levels that a currency loses any value (hyperinflation), forcing a country to start using a foreign currency—usually the US dollar (dollarization) rather than its own. Similar dynamics happened in the infamous cases of Zimbabwe and Venezuela, for example.

The International Monetary Fund (IMF) has traditionally insisted on the necessity to keep inflation below 5% (see **Box 2**). While low inflation is a valid goal, economists disagree whether this target should be prioritized over other necessities, for example employment creation or increasing public expenditure to achieve the SDGs. Economies have shown to be able to grow with inflation levels well above 5%. Hence, keeping a 5% inflation target as the main—or only—goal for monetary policies appears to be at least partially unjustified. Moderate (rather than low) levels of inflation can be appropriate in certain phases of a country's development.<sup>17</sup>

Moreover, a very low inflation is as detrimental as a very high one, as consumers will avoid buying goods because they expect prices to fall in the near future. Low or negative inflation (deflation) is often a symptom of a recession (resulting from people no longer having enough money to purchase the usual level of goods and services) and its occurrence is far more common than hyperinflation in advanced economies. For this reason, moderate increases in inflation (especially when coming from a situation of low inflation or deflation) can be positive, and a sign of economic growth. Despite that, too low inflation is often ignored and not (or insufficiently) addressed by policymakers.

This critical point about the consequences of pushing inflation too low has been raised over the years. For example, as far back 2001, a 2001 U.S. Government Accountability Office report on IMF loans, which explained: *"Policies that are overly concerned with macroeconomic stability may turn out to be too austere, lowering economic growth from its optimal level and impeding progress on poverty reduction."*<sup>21</sup> The 2008 Spence Commission on Growth and Development report also pointed to this specific concern in its report, saying *"Very high inflation is clearly damaging to investment and growth. Bringing inflation down is also very costly in terms of lost output and employment. But how high is very high? Some countries have grown for long periods with persistent inflation of 15–30 percent."* Commission member Montek Singh Ahluwalia noted, *"The international financial institutions, the IMF in particular, have tended to see public investment as a short-term stabilization issue, and failed to grasp its long-term growth consequences. If low-income countries are stuck in a low-level equilibrium, then putting constraints on their infrastructure spending may ensure they never take off."*<sup>22</sup>

## BOX 2: THE POWERFUL ROLE OF THE IMF IN SETTING MACROECONOMIC POLICIES<sup>18</sup>

**T**he IMF, along with the World Bank, is amongst the most significant norm-setters and influencers in the global financial system, and one of the most powerful forces in determining the shape of economic policies followed by low- and middle- income countries. With 190 member states, their rules apply to nearly every country in the world.

The IMF was established in 1944 with the initial aim of seeking exchange rate stability within the international monetary system. The rules of Bretton Woods, set forth in the articles of agreement of the IMF and the World Bank, provided for a system of fixed exchange rates. The rules further sought to encourage an open system by committing members to the convertibility of their respective currencies into other currencies and to free trade (i.e. the IMF originally had a narrow mandate of monitoring currency valuation in member countries). The 1970s and 1980s witnessed an expansion of the IMF's remit, to respond to countries' balance of payments difficulties, most famously, with the introduction of structural adjustment programs which saw it assume a more prominent role in shaping countries' broader economic policies when it began providing deeply indebted countries with bailouts.

Even though the IMF no longer engages in these 'structural adjustment policies', the Fund still wields enormous influence on countries' policy making. All member states of the IMF agree to country surveillance by the IMF. To carry out this role, the IMF continuously monitors a country's fiscal policies and overall economic conditions. In so doing, it aims to identify perceived risks to global economic stability.

More importantly, the IMF's powerful position at the apex of the international financial architecture, means it is both a key determinant of 'sound' economic policies and of a country's creditworthiness. Countries who ignore their advice can be placed in a negative position through limited access to IMF lending programs, or financial markets, or their perceived investment outlook, or relationships with other institutions. Even when the IMF's immediate lending leverage does not come into play, lower-income countries may be motivated to implement the IMF's advice to maintain perceptions of creditworthiness.

More broadly, the IMF is mandated by the international financial system to set guidelines for low and-middle income countries to maintain certain indicators in a conventional bandwidth it judges sound. At the macroeconomic level, the World Bank and the IMF continue to push a particular set of policy prescriptions across almost all their member countries. Most typically, these are fiscal consolidation measures (i.e. austerity), and include reducing the public wage bill, introducing or increasing VAT and other indirect regressive taxes, labor flexibilization, rationalizing (cutting) and privatizing public services, and targeting social protections and subsidies, while maintaining low levels of inflation, corporate taxation rates and trade tariffs.

The IMF therefore is significant in shaping countries' macroeconomic policies, from tax structures and debt, to the scale and scope of public sector provision, to inflation targeting.<sup>19</sup> Inflation targeting has become the received economic norm globally, with wide-scale agreement with IMF neoliberal orthodoxy, which seeks to reduce government 'intervention' in 'the market' and reduce regulation.<sup>20</sup>

**TABLE 1. ESTIMATES OF SAFE INFLATION THRESHOLDS FOR LOW- AND MIDDLE-INCOME COUNTRIES.**

	Author(s)	Inflation threshold (%)
<b>Academic papers</b>	Fischer (1992)	15–30
	Bruno (1995)	20
	Barro (1996)	10–20
	Bruno and Easterly (1998)	40
	Gylfason and Herbertsson (2001)	10–20
	Rousseau and Watchel (2022)	13–25
	Burdekin et al. (2004)	3
	Gillman et al. (2004)	10
	Sepehri and Moshiri (2004)	5–15
	Pollin and Zhu (2006)	14–16
	Li (2006)	14
	Vaona and Schiavo (2007)	12
	US GAO (2009)	5–12
	Bick (2010)	12
	Kremer et al. (2011)	17
<b>IMF papers</b>	Sarel (1996)	8
	Ghosh and Phillips (1998)	>5
	Kochar and Coorey (1999)	5
	Khan and Senhadji (2001)	11–12
	Selassie et al. (2006)	5
	Espinoza et al. (2010)	10
	Blanchard et al. (2010)	4

Source: Ortiz, et al 2017.

Therefore, there is both a danger of policies that are too ‘loose’ that can lead to large budget deficits or high inflation rates, and policies that are too ‘tight’ or which unnecessarily restrain public investment and GDP growth. What should be of great interest to civil society and advocates of increased public investment for achieving the SDGs should be the so-called ‘gray area’ or range of alternative options that fall in between these two extremes. The IMF may not trust such options, and prefers not to talk about them, but civil society advocates should know that there are in fact a range of viable alternative options that could allow for differing degrees of increased public expenditure and restraint.<sup>23</sup>

Given the existence of this gray area of intermediate options, it is also important to understand the degree to which moderate inflation (below 20% in low and middle-income countries) is not a positive nor a negative thing—it depends on the context and on what the drivers of inflation are. If moderate inflation is the result of an increase in public and private investment, which increases employment and wages, then moderate inflation may be worth the trade-off as a side-effect. This was much the way moderate inflation was understood in the decades before IMF structural adjustment loans began in the 1980s. But in this trade-off, the IMF prefers to trade away opportunities for higher investment, GDP and employment in order to get very low inflation.



However, civil society advocates are certainly free to consider other alternatives options. Just because the university economics textbooks have taught three generations of economists that there is only either very low inflation and fiscal deficits ('sound' and 'prudent' macroeconomic policies) or out of control instability leading to hyperinflation, with little in between, doesn't mean that civil society activists should remain stuck in that thinking.

It is crucial for civil society activists to understand that inflation is not a positive nor a negative thing in itself. Rather, an increase or decrease in inflation can be considered positive or negative depending on the circumstances. A moderate increase in inflation in an economy (especially from a situation of too low inflation or deflation) can be a sign of economic growth, whereas a decrease in inflation to very low levels can be a sign of economic recession. On the contrary, an excessive increase in inflation (especially when caused by a decrease in the aggregate supply) can have a negative and undesirable impact on real salaries.

Therefore, some crucial questions that policymakers have to answer are: what is causing inflation and what effect will different policy options have on inflation, and on other goals like employment? What levels of inflation are acceptable to finance public services, and to achieve the SDGs? And what levels can help achieve other economic and social policies in order to achieve maximum available resources for human rights?



### **COUNTRY EXAMPLE 3:**

#### **The case of Uganda— Using Monetary Policy to Control Inflation**

The Bank of Uganda adopted Inflation Targeting in July 2011, utilizing the Central Bank Rate (CBR) to manage inflation. If inflation increases above the target rate, the CBR is revised upwards.

Over the period 2011 to 2015, due to high inflation, the CBR increased from 13% in July 2011 to 23% in December 2011. After this date, due to inflation slowing down, monetary policy was loosened with the CBR reaching 13% in October 2012, and between November 2012 and June 2015 the average monthly change in CBR was -0.01%. In March 2022 (at the time of writing this handbook) CBR in Uganda was 6.5%. Overall, monetary policy partly contributed to the successful management of inflation, a key component of macroeconomic stability.

## KEY MESSAGES

- ▶ Tighter (lower) inflation targets limit the spending capacity of the governments.
- ▶ Less tight inflation targets allow the government to spend and invest more.
- ▶ An increase or decrease in inflation can be considered positive or negative depending on the circumstances. No one is in favor of inflation that goes too high (above 20% in lower income economies) which can diminish real salaries. But a moderate increase in inflation in an economy (especially from a situation of too low inflation or deflation) can be a sign of increased public investment and economic growth, whereas a situation of too low inflation can be a sign of economic recession.
- ▶ It is imperative for civil society to know that there are a range of alternative fiscal and monetary policy options for varying degrees of increased public investment in the so-called 'gray area' between policies that are too tight and those that are too loose, and such options must be better understood by civil society and be made the subject of discussion.

## The poverty and distributive effects of inflation

It is also important to stress that inflation has distributive consequences and that high and unstable levels of inflation are especially harmful for those on low incomes, when caused by a lack of supply (cost-push inflation or imported inflation) and not by an increase of the demand (because of increasing salaries and decreasing unemployment). If all prices (goods, services, wages, profits, etc.) increased equally, evenly, and predictably, inflation would not be a problem since nobody would suffer from it. In reality, inflation alters relative prices, giving gains to some and losses to others.

In general, those who have the lowest incomes are the least able to protect themselves from inflationary processes. Food and energy inflation are the most harmful for those on the lowest incomes because a large part of their budget is spent on food. Women are especially impacted because they make up a larger proportion of those on the lowest incomes and because they are the household members that are usually in charge of purchasing food and cooking energy. Other vulnerable categories that are most likely to be impacted by inflation are, informal workers, whose remuneration is unlikely to be anchored to inflation rates, and smallholder farmers, for whom inflation usually means higher input cost (e.g. for fertilizer). Conversely, people with higher incomes and wealth typically have additional access to financial instruments that protect themselves from inflation. For example, they have access to a wider range of consumer goods and can choose cheaper products; or if they are property owners, they often benefit from rents which are indexed to the inflation rate.

While inflation is harmful for those on low incomes, the best way to protect them from its negative impact depends on the context and the drivers of inflation. If inflation originates from external or domestic supply-side factors, there is little that monetary policy can do to dampen food price inflation on its own. The impact of food price inflation on poverty will depend on the extent to which the price rise is accompanied by a contemporary increase of the wage rates experienced by those on low wages. Monetary policy should be sufficiently reactive so as to avoid the temporary shock from feeding into an inflationary wage spiral, which would ultimately hurt those on low incomes the most, but it should also account for the fact that, in the absence of measures to remove the true causes of inflation, a tight monetary policy may further aggravate the problem by inducing stagflation. From the point of those on low incomes, the most useful responses to food price inflation are measures which limit the transmission of higher international prices to domestic markets; measures to promote the rapid increase of domestic food production and remove constraints faced by poor farmers so that they can take advantage of the increased food price; cash transfer programs adequately scaled up to face the crisis, ideally accompanied by nutrition interventions.

#### KEY MESSAGES

- ▶ High inflation affects those on low incomes, and informal workers the most (called a ‘negative distributional effect’).
- ▶ While inflation is harmful for those on the lowest incomes, responding to inflation using contractionary policies can further aggravate the situation, especially when it is caused by supply-side factors.

## The independence of the central bank

As we saw, central banks have the potential of financing a large part of the government expenditure. Before the 1980s, it was common for governments the world over to control central banks—indeed, the central bank was often seen more as a government department which worked alongside the Ministry of Finance. In fact, direct monetary financing (see section on ‘direct forms of monetary financing’) of government expenditures was the norm. Thus, governments had more freedom to reach their fiscal policy targets; for example, to finance investments in public services, welfare systems, social protection, all financed via (ideally, progressive) taxes.

During the 1970s, the neoliberal idea of central bank independence from government control became the standard model pursued by policymakers (including the approach championed by the IMF). The argument used here was that the enormous power of central banks to finance public spending, if left in the hands of politicians, creates perverse incentives for governments to spend too much, in order to please voters and stay in power. This supposedly generated inflation and price instability that hindered economic growth. As a result, the ability of the government to control and influence the central bank was reduced.

Nowadays, most central banks are independent. This means that central banks are legally prohibited in directly lending money to the government and take monetary policy decisions based on certain targets (mostly inflation targets) without direct influence from the government on policy implementation.

However, governments can indirectly influence central bank activities to a certain degree. Parliament and government influence the legislation around the functioning of the central bank, setting monetary policy goals (such as inflation targets) and deciding which instruments can be used by the central bank (open market operations, discount rates and so on). Thus, while nowadays the legislation determines the monetary targets and the central banks instruments, central banks decide independently which actions are required to reach such targets.

# Part 3

## Monetary policies, exchange rates, balance of payments and public debt

In the following section, we will see what the main limitations of monetary policies are and how they intersect with other macroeconomic aspects, such as exchange rates, public debt, and the balance of payments (in particular with the capital account). When arguing for more expansionary policies, which allow increased public expenditure and economic growth, policymakers should be able to understand the consequences such policies will have on macroeconomic outcomes.

### — How do monetary policies intersect with exchange rates?

An important aspect to consider when analyzing or advocating for monetary policies is the effect that they have on exchange rates. It is evident that monetary policies, by controlling inflation, influence the ability to purchase goods and services with a currency (its 'purchasing power'). This is true not only for the purchasing of goods and services, but also for the ability of a currency to buy other currencies – the exchange rate. This has an influence on the cost of goods going across borders, and impacts which goods are imported and exported.

Exchange rates influence international trade and the financial market. An exchange rate is in essence an expression of economic power of one country in relation to other countries and is a relative measure (it defines a relational dimension). Thus, an important decision for a country is how its currency is valued in comparison to other currencies. There are three ways to do so:

#### **a) Floating (or fluctuating) exchange rates**

This is a type of regime where a currency's value is allowed to freely fluctuate according to the foreign exchange market. Under this type of regime, countries can adopt any fiscal and monetary policy, and the currency value will vary according to the supply of and demand for it in the foreign exchange market, where those who trade currencies (including government but also corporations or individuals who trade in capital markets). Basically, if a currency is in high demand in the foreign exchange market, it means that it is more valued in comparison to other currencies, and its exchange rate increases. Conversely, when market participants prefer to sell a currency rather than buy it, its exchange rate decreases.

The availability of a currency (i.e. the money supply) affects how much a currency is demanded in the foreign exchange market. Let's imagine that a country decides to adopt very expansionary monetary policies and lowers interest rates: because a currency is suddenly more easily available, the demand for the currency will become lower than its supply. Moreover, when the central bank lowers the interest rate, investors will sell the currency to shift their money abroad, in search of more favorable interest rates. This will cause the currency to lose value in the foreign trade market.

In other words, expansionary monetary policies will tend to cause a currency depreciation (i.e. a loss in value) in international trade, whereas contractionary monetary policies will tend to cause a currency appreciation (an increase in value).

## b) Fixed (or pegged) exchange rates

This is a system where governments try to maintain their currency value constant against a specific currency or goods that are used in international trade, like US dollars or gold (the so-called gold standard). Fixed exchange rates encourage international trade due to price stability.

Under this regime, central banks must “defend” the exchange rate: it means that they must ensure that the exchange rate remains constant while demand and supply of the currency may fluctuate. To do so, it must have a reserve of the foreign currency which is used as a reference. This is because the country must be able to purchase all offers of its currency at the established exchange rate. Therefore, during a time of high market demand for the foreign currency, the central bank will have to sell the foreign currency from its reserves and buy back the domestic money.

## c) A pegged float exchange rate

This is a system that fixes an exchange rate around a certain value, but still allows fluctuations, within certain values, to occur. It represents a hybrid between fixed and floating regimes. A notable example is the Bretton Woods system, where currencies were pegged to the value of the US Dollar but allowed for minor fluctuations (of 1-2%) to occur.

### DEFINITIONS

**Purchasing power:** the value of a currency expressed in terms of the amount of goods or services that one unit of money can buy.

**Exchange rate:** the value of one currency for the purpose of conversion to another.

**Depreciation:** a decrease in the value of a currency in a floating exchange system.

**Appreciation:** an increase in the value of a currency in a floating exchange system.

**Devaluation:** a deliberate decrease of a currency's exchange rate in a fixed exchange rate system.

**Revaluation:** a deliberate increase of a currency's exchange rate in a fixed exchange rate system.

## — Exchange rates and balance of payments.

The balance of payments is a method to document all international monetary transactions of a country. The management of the balance of payments is an important aspect of a country's monetary policy because it has an impact on the quantity of money in circulation in the economy and on the domestic interest rate. In fact, the balance of payments monitors how much money is going in and out of the country. If the country receives money, this is registered as a credit, whereas if the country has paid or given out money, this is accounted as a debit. In theory, the sum of all transactions should be zero.

The balance of payments has two main components:

- ▶ The current account balance, which records all the inflows and outflows of goods and services. Earnings on investments, both public and private, and on the sale of goods and services are also recorded under this.
- ▶ The capital account balance, which records all international monetary flows related to investment in business, real estate, bonds, and stocks.

Both accounts can have different degrees of openness. A country that allows free international trade has a very open current account (meaning that there are no or few restrictions to import and export). A country with an open capital account allows the free inflows and outflows of capital from other countries. As discussed below, the more open the capital account is, the more a country's monetary policy is affected by global financial movements.

In a floating exchange rate system, the relationship between the balance of payments and exchange rates will be driven by the supply and demand of a currency, and consequently, all the transactions taking place. For example, a depreciation of a currency typically makes imported products more expensive, as the value of the currency is less and so is its purchasing power in relation to other currencies—because they have to be purchased using a foreign currency (which has become more expensive due to the devaluation). Conversely, an appreciation makes exported goods cheaper, as the purchasing power of a currency has gone up and thus increases the export and decreases the imports of a country.

In a fixed exchange rate system, countries can devalue a currency, meaning that they can deliberately decide that the national currency will lose value in international trade. This may sound counterintuitive, but a devaluation can be a strategy for the national economy. Just like depreciations, devaluations can make national products more attractive in the country and abroad, as they become cheaper in the international market, in contrast with imported products which will become more expensive.

Conversely, currency devaluations and depreciations often trigger large capital flights, as foreign investors tend to flee from countries where prices and exchange rates are unstable, before their assets lose too much value. Moreover, devaluations and depreciations also affect import prices (which go up) and cause upward inflationary pressure.

## The impossible trinity

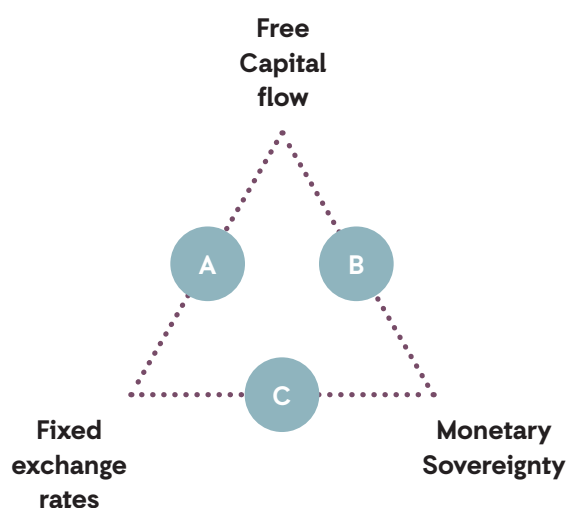
To easily grasp how balance of payments, exchange rates and monetary policies influence each other, it is useful to introduce the concept of the *'impossible trinity'*.<sup>24</sup>

This concept states that free capital movement, monetary sovereignty and fixed exchange rates cannot coexist. Countries will hence have to give up one of these three goals to maintain an equilibrium.

For example, to maintain fixed exchange rates and free capital flow (situation A), countries must necessarily give up their monetary sovereignty (i.e. the ability to conduct monetary policies and set interest rates independently), because its exchange rate will flow following the currency markets and its interest rate will be entirely determined by foreign capital movements. Failing to do so will inevitably break an equilibrium that will lead the country to abandon the fixed exchange rate (or alternatively to regulate capital flows).

To better understand this, let's imagine a situation where a country tries to pursue all 3 goals at once: it liberalizes capital flows, pegs its exchange rate to another currency and tries to maintain monetary sovereignty. When the country decides to implement expansionary policies and lowers interest rates, inves-

FIGURE 1. THE IMPOSSIBLE TRINITY





tors will start to borrow large amounts of currency from that country (as money is more readily available). They will then reinvest the money in other countries, where interest rates are higher. Without capital control measures, a large capital outflow from the country will occur. Thus, the central bank of the country will have to buy back the national currency, in order to defend the fixed exchange rate. This will lead to a depletion of the reserve currency, which is used to buy back the national currency. Once the reserve currencies are depleted, the central bank won't be able to defend its national currency and will be forced to abandon the fixed exchange rate regime. If a country were to choose to close its capital account to control capital movements in and out of the country, it could have fixed exchange rates and monetary sovereignty, but at the expense of international financial integration (situation C).

According to mainstream neoliberal economics, such a situation is considered undesirable and almost impossible to achieve, because attempts to control capital flows would bring distortions in the 'market', which would hinder investment and economic growth. Therefore, 'modern' countries should choose between fixed exchange rates with free capital flows (situation A), or monetary sovereignty with free capital flows (situation B).

Of course, not all countries have the same freedom over their monetary policies, due to their historic economic position in the global economy. Countries in the Global South are especially restricted, meaning they can't always choose floating exchange rates. On the grounds of this argument, low- and middle-income countries have for decades been pushed into indiscriminate capital account liberalization to allow the free inflow and outflow of foreign capital, facilitating wealth accumulation. Hand in hand with deregulation of the financial sector this has often had harmful effects, contributing to financial crashes and increasing inequality in many countries.<sup>25</sup> Some have even argued that the global financial cycle has turned the trilemma into a 'dilemma' or an 'irreconcilable duo': that is, independent monetary policies are possible if and only if the capital account is managed.<sup>26</sup>

The loss of monetary independence with capital account liberalization is problematic in low- and middle-income countries with small, vulnerable, and volatile economies. This is especially the case in lower-income countries that are also commodity-dependent, export-led economies that rely on the export of one or a few primary goods (such as oil or lithium, for example) and import most consumption goods and where the exchange rate is strongly affected by global prices and demand.

Moreover, the global economic impacts of the Covid-19 has contributed to the re-emergence of sovereign default risk, especially for low- and middle-income countries, and has directed attention to international credit rating agencies, who are tasked with predicting defaults, and thus wield significant power. Yet the influence of credit rating agencies can have detrimental impacts in these countries, leading to potential bias in ratings, pro-cyclicality of ratings, governance issues and conflicts of interest.<sup>27</sup>

#### KEY MESSAGES

- ▶ Any monetary policy decision has great consequences on the exchange rates, which will in turn influence the flow of capital. Such aspects must be considered by central banks, whose mandate is also to maintain financial stability.
- ▶ Many lower-income countries face strong constraints to their monetary sovereignty and more generally they have limited policy space, especially if they have a very open capital account and/or their economies are commodity-dependent and export-led.



## COUNTRY EXAMPLE 4:

### Brazil's answer to the impossible trinity: the Macroeconomic Tripod

Since 1999, an economic policy regime called the 'macroeconomic tripod' has been in force in Brazil. The policy consists of the simultaneous adoption of three policies:

1. the primary surplus target regime, that is, a commitment for the primary public budget to be in surplus (fiscal policy);
2. the floating exchange rate regime (exchange policy);
3. and, the inflation targeting regime (monetary policy).

Its theoretical foundation is based on the New Macroeconomic Consensus (NCM), a convergence of macroeconomic ideas from Neoclassical and Neo-Keynesian Economics that emerged within the scope of mainstream economics. NCM's

theoretical framework guides economic policies by the notion of "one objective, one instrument". The fiscal regime aims to stabilize or reduce the public debt/GDP ratio through the generation of primary surpluses. The goal of the adjustment on external accounts would be achieved through the floating exchange rate, in association with external market opening. And price stability, in turn, would be achieved through management of the base interest rate in an inflation targeting regime.

Critics of the tripod in heterodox economics point out that although the macroeconomic tripod has been successful in controlling inflation in Brazil's recent history, it has proved inadequate in terms of creating a macroeconomic environment conducive to sustained growth with income distribution, and a reduction in inequality. It has also not resulted in the 'macroeconomic stability' suggested by its advocates. They point to three sets of evidence of its failure: (i) the Brazilian economy has faced high nominal interest rates, which harm investment and credit availability for people and companies; (ii) the Brazilian exchange rate, in relation to \$USD, is one of the most volatile in the world (iii) the fiscal regime is pro-cyclical and incapable of guaranteeing the stability of the public debt/GDP ratio as well as safeguarding social spending. Moreover, a spending cap for federal public investment was put in place in 2016 which caps spending until 2036. Under the new rule, the federal government's primary spending is limited by a spending cap based on the previous year's maximum amount adjusted for accumulated inflation. In other words, total primary spending is frozen for 20 years at the same level as 2016.

## DEFINITIONS

**Domestic public debt** is the debt that the government owes to its central bank, local banks, and financial institutions, families, and companies residing in the country.

**Foreign public debt** is the debt that the government owes to foreign banks and financial institutions.

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## — Monetary policies and public debt

The public, or ‘sovereign’, debt is the amount of money that a government owes to its creditors. It can be broadly divided into domestic and foreign debt. Domestic debt is denominated in local currency and foreign debt is denominated in the currency of the borrower’s country. Monetary policies have an important effect on both local and foreign public debt, also due to their effect on inflation and exchange rates.

### **Effect on domestic public debt**

As we already discussed in previous sections, governments issue debt of various maturities to finance spending. Central banks conduct open market operations, which involve sales and purchases of government bonds to influence the interest rate. The government has to pay interests on its bonds aligned with the rate established by the central bank. The owners of the government bonds, such as the central bank, commercial banks, and individual investors, receive earnings on their bonds according to the level of interest rate. However, since the majority of the profit of the central banks is typically sent to the government, the cost of the public debt owned by the central bank is virtually nothing. Basically, the central bank sends back to the government almost all profits made through ownership of government bonds.

Therefore, expansionary monetary policies can help to make public debt more manageable (by lowering interest rate), whereas contractionary monetary policies make public debt more expensive (by increasing the interest rate). The higher the interest rate, the more expensive it is for the government to finance itself via public debt.

Furthermore, expansionary monetary policies can increase inflation rates. This may sound counterintuitive, but inflation has a positive effect on domestic public debt. As inflation is the loss of value of a currency, when inflation increases, the real value of the public debt decreases. In other words, inflation allows borrowing governments to pay lenders back with money that is worth less than what it was when originally issued.

This effect is however temporary: as inflation increases, investors will seek higher returns on their investments, as their returns are eroded by the loss of the currency value. Hence, they will charge a higher interest rate on the new debt to compensate for the loss of purchasing power.

Another important aspect of public debt is its distributional effects. An increase in the interest rate means a higher yield for the holders of these bonds. This has distributive impacts, since most debt holders around the world are financial institutions and investment funds, controlled by the wealthy. Since the tax structure of a country also has distributional effects, it is important to always balance the two possibilities of government financing with its pros and cons in terms of distributional effects to decide which tool is better in each situation and to mitigate any harmful impacts.

### **Effect on foreign public debt**

Monetary policies have an opposite effect on public debt when this is denominated in a foreign currency. Because expansionary monetary policies tend to cause the depreciation of the country’s currency, foreign debt will worsen—as the price of the foreign currencies in which the debt is denominated increases. Contractionary monetary policies, instead, will help to maintain foreign debt stability, as it keeps exchange rates stable.

### **General considerations on public debt**

Looking at the history of economic policy, it is more effective to resolve a situation of outstanding public debt using expansionary policies, rather than by running fiscal surpluses, i.e. constricting public spending or increasing taxes that require austerity measures (fiscal restrictions), which have negative socioeconomic consequences. Indeed over the past forty years austerity policies have led to cuts in the public sector workforce that have undermined the governments’ ability to deliver quality public services.<sup>28</sup>

The use of expansionary monetary and fiscal policies that push the growth rates above the interest rate, artificially low interest rates and above-expectation inflation have been historically more effective to reduce public debt than fiscal surpluses obtained through austerity measures.<sup>29</sup> Pursuing this strategy requires two preconditions: a central bank that supports the expansionary policies of the government; and, a stock of public debt that is denominated in domestic currency.

With domestic debt, the central bank can always issue money to buy back maturing debt; for this reason, governments that issue debt in domestic currency cannot be forced into default by markets, and they are only vulnerable to inflation risks. By contrast, when a country's public debt is denominated in foreign currencies, the country can lose 'market confidence', through credit rating agencies.<sup>30</sup> Low and middle-income countries face constraints to adopting this strategy because typically a large share of their public debt is denominated in foreign currency.

#### KEY MESSAGES

- ▶ Monetary policies have opposite effects on domestic and foreign public debt:
- ▶ Expansionary monetary policies tend to lower domestic public debt, whereas contractionary monetary policies tend to increase it.
- ▶ Expansionary monetary policies tend to increase foreign public debt, whereas contractionary monetary policies tend to lower it.

# Part 4

## Monetary and fiscal policy—trends and theories

Up until this point, the focus has been on the technical functioning of monetary and fiscal policies and how they intersect with other macroeconomic aspects. In this part, the different schools of thoughts in monetary policy theories are outlined, and how they have been historically translated in the global economy.

### — Keynesian economics and embedded liberalism


Keynesian economics was developed by the British economist John Maynard Keynes (1883-1946) who is considered the ‘father’ of macroeconomics, as the first economist to study broad economic variables and constructs, rather than studying the behaviors of markets based on individual incentives. Notably, Keynesians argued that governments should stimulate economic growth (for example to pull a country out of an economic crisis) adopting expansionary monetary and fiscal policies, with the objective of increasing aggregate demand and pursuing full employment. Thus, Keynesian economics advocated for active state ‘intervention’ and expansionary fiscal policy to stimulate or modulate growth as necessary—recognizing the positive role of the state in the economy.

Keynesian theories laid the foundations for the construction of the global economic system that was put in place after 1944, which some academics called ‘embedded liberalism’.<sup>31</sup> This system allowed for relative financial stability, as countries fixed their exchange rates to the US Dollar through a monetary agreement that was called the Bretton Woods system. At the same time, countries maintained their monetary sovereignty, allowing for expansionary policies to finance public services and infrastructural investment. This was possible because at the time, capital control measures were widely accepted and used (see the part on the “impossible trinity”).

During this 40 year-period,—from the 1940s to the 1970s—it was common for fiscal policy goals to lead, and for monetary policy to be adjusted accordingly. Governments around the world commonly adopted expansionary fiscal and monetary policies to achieve developmental goals. Monetary policies were generally used to lower interest rates, which made deficit spending more affordable for governments, and thereby accommodated the pursuit of more expansionary fiscal policy goals such as scaled-up public investment in education, health, public transport, and infrastructure, all of which provided for increased worker productivity rates and higher GDP growth. Moreover, the banking and financial sector worked very differently at the time and were a much smaller percentage of the global economy.

### — Monetarism and neoliberalism

In the 1970-80s, economic shocks, such as the oil crisis, caused inflation and unemployment to rise. During this period, there was a major emphasis on the need to get high inflation under control in many countries, which led to a deep rethinking of the macroeconomic system. Price stability became the main objective of monetary policies, according to a new school of thought that was called ‘monetarism’. Under this school of thought, theorized by economists like Milton Friedman, central banks’ primary role was to keep prices stable. The rationale of this school of thought was that price stability (obtained by keeping inflation low) and ‘free markets’ would allow private investment to stimulate economic growth.



Before monetarism, expansionary policies were used to keep unemployment low, according to a macroeconomic model (the ‘Phillips curve’) that stated that there was an inverse relationship between inflation and unemployment. However, monetarists argue that expansionary monetary policies, in the long run, would only cause inflation to rise, without generating economic growth or delivering low unemployment.

Another rationale for this approach was the assumption of ‘rational expectations’, which stated that individuals base their decisions on human rationality, available information, and past experiences. Hence, the ability to predict prices (i.e., a low and stable inflation rate) would allow the individuals to make rational economic decisions, enabling markets to work optimally without external ‘interference’ and regulation from the government,<sup>32</sup> gradually lowering unemployment and promoting growth.

The conclusion of these two assumptions was that the most effective macroeconomic policies should be aimed at keeping inflation low and stable, rather than allowing for central bank and government ‘intervention in the economy’ to lower unemployment and promote growth.

This school of thought led to a new set of macroeconomic policies (called ‘neoliberalism’) to be introduced. Under neoliberalism, capital control measures were abandoned in order to facilitate the inflow of capital, which in turn was supposed to help stimulate investment and growth. Moreover, central banks were made ‘independent’, which allowed them to control inflation more easily, as monetary policies were not used to finance government’s expenditure anymore. Advocates of neoliberal policies argued that ‘free markets’ through unrestricted and unregulated flows of capital was key to economic growth, and that ‘government’s intervention’—through monetary and fiscal policies—should be minimized to allow ‘the free market’<sup>33</sup> to take care of regulating the economy.

Therefore, since the 1980s, the scope for monetary policy has narrowed considerably, being reduced to one main policy target (low levels of inflation) and sometimes a secondary one (full employment) and one main policy instrument (raising interest rates). As mentioned previously, contractionary monetary policies that raise interest rates make governments more reluctant to spend, because of the higher interest rates that they have to pay on debt. As a result, the advent of monetarism has led to a progressive contraction of government spending in public services and public investment, contributing to cuts in public services and privatization and the selling off of government assets leading to profits for wealth holders. At the same time, the increased emphasis on the liberalization of trade and capital flows allowed for measures to deregulate corporations, weakening workers’ bargaining power (and thus salaries), as well as minimizing taxes. The following picture provides an overview of the main differences between macroeconomic policies during embedded liberalism (1945-1980) and neoliberalism (1980-2004).



**TABLE 2: COMPARISON BETWEEN MACROECONOMICS DURING EMBEDDED LIBERALISM AND NEOLIBERALISM**

Characteristic	Embedded Liberalism, 1945–1980	Neoliberalism, 1980–2004
Trade barriers	High	Low
Capital control	High	Low
Power of state relative to capital	High	Lower
Strength of unions	Strong	Weakening
Business regulation	Strong	Weakening
Status of social spending	Secure	Less Secure
State-owned enterprises	Prevalent	Disappearing
Development strategy	Domestically generated	Export orientated
Focus on government policy	Geopolitical conflict	Economic competition
Currency markets	Prices set by multilateral agreements	Prices set by global markets

Comparison between macroeconomics during embedded liberalism and neoliberalism—From: Cohen, J. N., & Centeno, M. A. (2006). Neoliberalism and patterns of economic performance, 1980-2000. *The Annals of the American Academy of Political and Social Science*, 606(1), 32-67.

We can see how this paradigm shift in the view of fiscal and monetary policies and in the underlying economic theory and thinking, which favored the idea of ‘free markets’ (i.e. benefiting those with wealth, capital, or assets) influenced the financing of public services, the redistribution of wealth, the bargaining power of workers, and many other socioeconomic aspects. This was justified by the idea that the main objective of monetary policies was to maintain price stability to support trade and private sector activity (by lowering inflation), and that fiscal targets should follow.

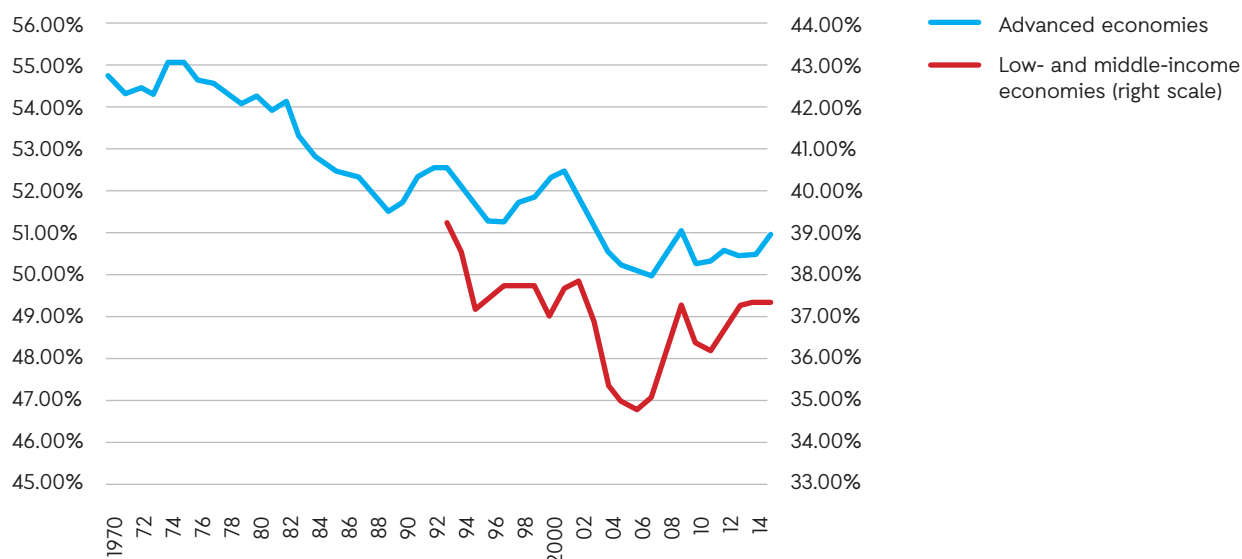
## — Rising inequality: a problem of our time

The advent of neoliberalism, along with more restrictive monetary policies, has caused an increase of inequality, which is currently in overdrive as capital and wealth is becoming hyper-focused in the hands of a few. The slashing of public services, government austerity, the liberalization of capital flows and the decrease of (progressive) taxation, that together characterize neoliberalism have had (and continue to have), a sharp effect on economic inequality. In the previous period, between 1940-1970s, income inequality had steadily decreased in many countries. During this period, low and middle incomes increased the most, whereas the income of the richest class remained relatively constant. This trend slowed down in the 1970s, and inequality started to rise after the 1980s.

This inequality can be seen in the reduction of the overall share of income to labor (compared to capital owners) declining since the 1970s. To provide an example, Figure 1 shows the decrease of the labor share of national income since the 1970s (i.e. wages and income), in contrast to the capital share, (i.e. the part of national income distributed as capital income such as interest, profits, dividends, and capital gains). This can be a useful indication of inequality growing, given that the share of capital tends to go to the wealthy in society (compared to increases in wages which tends to benefit the wealthier less).

While it can be argued that the neoliberal approach is not necessarily better for economic growth than the Keynesian approach (countries experienced significant economic growth between the 1940s and the 1970s) it can be argued that mainstream neoliberal policies are connected to inequality. Specifically, financialization,<sup>34</sup> mainstream monetary policies,<sup>35</sup> and capital liberalization,<sup>36</sup> are all connected to a decreasing share of income through wages (i.e., the labor share of income) since the 1970s.

FIGURE 2. EVOLUTION OF LABOR'S SHARE OF THE INCOME: 1970-2014



Source: Routinization, globalization, and the fall in labor's share of income.

Crucially, a recent (January 2021) publication from the World Bank connects the emergence of central bank independence in the 1980s to economic inequality, as it constrains policymakers to steer overall macroeconomic outcomes, respond to adverse shocks, and impacts the fiscal space.<sup>37</sup>

## The 2007/08 financial crisis

The debate around the necessity of returning to Keynesian economic measures and resorting to more expansionary policies was reopened after the 2007 financial crisis. The necessity to stimulate investments and recover economic growth eventually caused many governments—in the Global North—to adopt unconventional monetary policies, such as quantitative easing, through which investors could finance public expenditure. For example, the Federal Reserve mobilized USD\$16 trillion to bail out commercial and investment banks that were undergoing severe losses during the crisis.<sup>38</sup>

The justification for such expansionary monetary policies was that inflation was falling below the desirable levels, due to the deep economic recession that many countries were facing. Although many economists warned that resuming expansionary policies would cause inflation to rise to dangerous levels, this did not happen, and central bankers have consistently fallen short of their inflation and growth targets until recently (trends have started to reverse with the Covid-19 pandemic, see below).

Many economists<sup>39</sup> have noted that monetary policies have become less effective in boosting the economy, as many countries faced economic recession or slow growth despite the interest rates having been very low for more than 10 years after 2009. In response to that, it can be argued that while these countries adopted expansionary monetary policies with low interest rates, they have continued to pursue contractionary fiscal policies (austerity), which inhibited economic recovery.<sup>40</sup>



## — The Covid-19 crisis and the state of the debate

The arrival of the Covid-19 pandemic required massive government spending for healthcare and social protection, and caused a fall in GDP and tax revenues due to Covid related measures (which implied the shutdown of many economic activities) and the consequent economic crisis. This led high income country governments to adopt expansionary monetary policies, which allowed for unprecedented deficit spending and monetary expansion. Central banks and governments in high income countries worked together to support the economy and to finance massive expenditures in healthcare and social protection.<sup>41</sup>

These situations are inevitably leading economists to re-think the role of central banks and reopen the discussion about the use of monetary policies to finance government expenditure. Signs that the debate around monetary policies is reopening can be seen in the political landscape of Europe and the US, such as US president Biden's choice of Stephanie Kelton<sup>42</sup> (a famous proponent of more Modern Monetary Theory) as economic advisor, or the recent declaration of the former European Central Bank president Mario Draghi, who suggested that the European Central Bank should start exploring alternative, more accommodating macroeconomic policies such as Modern Monetary Theory.<sup>43</sup>

The explosion of the Covid-19 pandemic and the health, social and economic crises that ensued have triggered a reverse in trends of interest rates and inflation, that are on the rise again. In fact, the disruption of the supply chains and international trade caused cost-push and imported inflation. At the time of writing in April 2022, this reversal is being magnified by the spillover from the Russian invasion of Ukraine.

This situation caused a further challenge for the proponents of expansionary fiscal and monetary policies. Some argued that the massive fiscal expansion—particularly in the US—is one of the current causes of high inflation, which is leading the Federal Reserve to adopt less expansionary policies and increase interest rates.

It is important to recognize and address the consequences of inflation, especially on poor and vulnerable populations. However, this should not lead to the simplistic conclusion that, to address inflation, it is necessary to adopt contractionary policies (like fiscal consolidation measures or increasing the interest rates). In fact, expansionary policies were necessary to face the enormous crisis, and the consequences of not adopting expansionary policies would have probably been more devastating.

This is especially true for low- and middle-income countries, where expansionary fiscal policies have been limited and short-term. Moreover, the recent intention to raise the US interest rates will have repercussions on the global economy, and will imply much higher cost of borrowing for low- and middle-income countries. A nuanced way to address the current debate requires the recognition of the negative impact of both inflation and austerity.

## — Monetary policies in low- and middle-income countries and the role of the IMF

While some middle-income countries (such as Indonesia<sup>45</sup>) followed the example of the US and European countries and used their central banks to finance public expenditure and monetized the public debt contracted during the Covid-19 pandemic, many do not enjoy the same degree of monetary sovereignty. This means that their monetary policy is strongly affected by exogenous factors such as fluctuations in the global demands and price of goods and in financial global markets and that they enjoy limited policy space. This occurs for many reasons.

### BOX 3: MODERN MONETARY THEORY (MMT)

**M**MT is a macroeconomic theory that considers governments as ‘currency monopolists’ and sees underemployment as a result of an insufficient money supply from the government. According to MMT, governments don’t have to collect taxes in order to fund their expenditure: as governments are the source of all money, they literally spend money into existence, injecting cash into the economy. As the government is the currency issuer and cannot run out of money, the concerns around public debt are not relevant. Instead, the only limit to government spending is inflation, which occurs when the money supply exceeds the capacity of the economy (in terms of employment, raw materials, etc).


Like Keynesian economists, supporters of MMT argue for more expansionary monetary policies, as the existence of underemployment is a sign that the money supply has been constantly below the capacity of the economy. Because of their similarities, many argue that MMT is a revisited version of Keynesian economics.<sup>44</sup>

In the first instance, many low- and middle-income countries are export-led, commodity dependent economies: this means that their economic growth is dependent on the export of a primary commodity that they produce abundantly (for example, fossil fuels or coffee). These economies can see the value of their currency fluctuate with the price of the commodity that they export. If they want to maintain their exchange rate stable, they have to give up other monetary policy objectives, including inflation. Commodity exporting countries often have very low productive capacity, meaning that they depend on importing basic food and other consumption products. At the same time, they typically have very low tax revenues, partly due to illicit financial flows and tax evasion, meaning that they depend on high levels of external borrowing to pay for their imports. These high levels of external borrowing constrain domestic monetary policies because the interest rate must be kept high enough to attract foreign loans. Overall, for many reasons, low- and middle-income countries are characterized by high levels of subordination in the global monetary and financial system (see also the above section on the “impossible trinity”). But these realities are, at least partly, also rooted in economic structures, institutions and policies that are deeply shaped by colonialism and its inescapable legacies like racism and other location-based power differentials.

Another factor that constrains policy space in low- and middle-income countries is the fact that monetary and fiscal policy decisions are crucially influenced by the IMF, whose economic view is aligned with the mainstream neoliberal positions which call for low and stable inflation as the primary policy target, a flexible exchange rate and an open capital account (see **Box 2**).<sup>46</sup>

Standard IMF policy advice or loan conditions call for keeping inflation at very low levels (about 5% or lower), and for keeping government fiscal deficits below 3% of GDP in low- and middle-income countries. But these targets can amount to serious constraints on the ability of countries to affordably maintain or increase public investments needed to achieve the SDGs. For example, all too often, when health and education ministries seek to get increased funding in their annual budgets to move forward with efforts to achieve the SDGs, they are told by their finance ministries that meaningful increases are not possible. This is because of the belief that fiscal deficits and inflation must be kept at very low levels in order to adhere to the IMF’s preferred definition of ‘macroeconomic stability’, reinforced by credit rating agencies and the financial sector.

But in the era of the SDGs, when low- and middle-income countries are being called on to mobilize more domestic resources, must inflation rates and fiscal deficits always be kept so low? This is a key question which should be explored.



The IMF's position that inflation must be kept at 5% or lower, and fiscal deficits below 3% of GDP in low- and middle-income countries is not grounded in a strong evidence base. Recent research suggests that there is scope for more expansionary options to be considered. This was the point raised in 2017 report by the ILO, UNICEF, and UN Women,<sup>47</sup> which called for low- and middle-income countries to adopt a more accommodating macroeconomic framework that “entails permitting higher budget deficit paths and/or higher levels of inflation without jeopardizing macroeconomic stability” as a way to mobilize more resources domestically.


Critics of tight monetary policies have questioned if the IMF's fiscal and monetary policies used to achieve such low inflation are in fact too restrictive and might constrain the ability of countries to mobilize more domestic resources. In low- and middle-income countries, where high informal work and technical difficulties in collecting taxes constrain the ability of the government to collect revenues, as do illicit financial flows and tax evasion undermine financing public investment with central bank money can be a valuable option.

For example, in order to get inflation down to low levels and keep it very low, central banks typically use their overnight rate, or “bank rate” (the interest rate at which they lend to other banks), to raise interest rates to quite high levels in low- and middle-income countries (often between 15-25% or higher), which can quickly make any deficit financing by governments less affordable. The net effect is to constrain public spending, and public investment as a percentage of GDP. When overall public spending gets squeezed, most of the budget goes to immediate needs and recurrent expenditures and often little is left over for scaling up long-term public investment in infrastructure, including the underlying infrastructure for the public health and public education systems and transport infrastructure.

Thus, while most low- and middle-income countries have safely established ‘macroeconomic stability’ under the last few decades of IMF loan programs or policy advice, there are concerns about if the IMF's definition of macroeconomic stability may be too austere. As shown in Part 2 a number of sources have voiced long-running concerns about the overly restrictive nature of IMF policies, and if they are constraining governments from scaling-up public investment. Studies that have tried to find the “kink” in the inflation-growth relationship, or at what level inflation begins to hurt a country's future long-term GDP growth rates (see **Table 1 in section 2** above), show that estimates are varied and further research is needed. Overall, there is no consensus nor justification for inflation-targeting policies, nor the need to push inflation so low, as they are currently practiced throughout the middle- and low-income countries.<sup>48</sup> The same literature was reviewed in a study<sup>49</sup> by the Washington DC-based Centre for Global Development, found: “Empirical evidence does not justify pushing inflation to these levels in low-income countries.”<sup>48</sup> When the House Financial Services Committee of the U.S. Congress explored this issue in 2007, it sent a letter to the Managing Director of the IMF stating: *“We are concerned by the IMF's adherence to overly-rigid macroeconomic targets” and “[i]t is particularly troubling to us that the IMF's policy positions do not reflect any consensus view among economists on appropriate inflation targets.”* Yet, the IMF continues to wield enormous power around the world, in spite the fact that there is no broad consensus on the right answer to this question in peer-reviewed literature in economics.

## — Supporting a just transition and facing future crises

After the 2016 Paris Agreement on Climate change,<sup>50</sup> the Paris Pledge for action,<sup>51</sup> and the creation of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS),<sup>52</sup> the debate on the mandate and independence of central banks was reopened. Central banks can influence markets and promote green investment, for example, by increasing the share of green bonds in their portfolio of open market operations, and support governments in financing green policies. This type of action clearly requires a rethinking of central banks' independence and purpose, both on their influence on



private markets and fiscal policies. Moreover, also in the case of climate change, the range of actions of central banks is severely limited by their mandate of price stability and their inflationary targets. So far, the need for supporting the green transition through central bank policies only led to very weak policy commitments, without any substantial change in the functioning of central banking, as in the case of the European Central Bank.<sup>53</sup>

More broadly, the world faces a series of interconnecting crises—from the Covid-19 fall-out, climate, and inequality—and responding to them will entail a complete departure from business-as-usual, and a recognition that the current macroeconomic model is failing the people and the planet. It will necessitate an exit from a neo-colonial, fossil fuel dependent, emissions-intensive economies, by reorienting economies to place wellbeing, care and public services at the center. To support a just transition, governments require significantly more financing—an approach at odds with the current dominant economic model.<sup>54</sup> Central Banks will be called upon to better respond to these crises. Indeed, to keep within planetary boundaries, and to better serve the people and the planet, there is a need for a complete rethink and new approach to economic development. This requires rethinking how people's time is used, in order to produce what, and how money is directed; which may require monetary policies which can better help support a fairer, greener and more gender equal world.

# Part 5

## Conclusion and call to action

### — The need for civil society advocacy on monetary policies

Monetary and fiscal policies are valid tools that can be used to mobilize domestic resources and increase fiscal space. For this reason, we invite CSOs who advocate for increased resources allocated to public services, to scrutinize the macroeconomic policies of their countries and look at how monetary and fiscal policies are conducted. In particular, we invite civil society organizations to look at these aspects:

- 1 How is the central bank **governed** in your country (*e.g., through control by Parliament, through the IMF, a board of directors, the Minister of Finance, including public hearings with civil society, etc.*)?
  - a. Is this governance approach well-justified given the country's (institutional and historical) context?
- 2 Which fiscal and monetary policy **objectives and targets** are followed? (*e.g. unemployment, economic output, fiscal balance, fiscal debt, different measures of inflation, money supply growth, exchange rate regime, trade balance, financial stability, financing of strategic priority sectors*)
  - a. Are the current monetary and fiscal policies pro-cyclical or counter-cyclical?
  - b. Are the achievement of development goals and the financing of public services prioritized in monetary and fiscal policies? Or do they prioritize inflation goals?
  - c. Are these policy objectives and targets well-justified given the country's context?
  - d. What are the constraints for implementing expansionary policies in your country?
  - e. In particular, what is the debt position of your country? Is this foreign or internal debt? And how does this influence the monetary sovereignty of the country?
- 3 What **instruments** are used to achieve these objectives and targets? *e.g. direct monetary financing (advances to Treasury to overcome cash flow problems, financial repression), indirect monetary financing (open market operations, liquid asset requirements for banks), devolved financing (of public development banks and strategic priority sectors), capital and financial market regulation and development initiatives, etc.)*
  - a. Are these well-justified given the country's context?

Being aware of these issues can greatly help directing advocacy efforts and thus mobilize much needed resources for public services.





## — A call for action for civil society organizations

Fiscal and monetary policies are not apolitical, technocratic choices made by bureaucrats who are following clear rules about getting the numbers right. Rather, they reflect inherently political choices.

This point has been underscored in recent years by the excellent work of advocates for more progressive taxation to address worsening economic inequality in countries. These groups have shown that choices about tax policy—if a national tax structure should be more progressive or more regressive—are in fact very political choices, not apolitical or technocratic decisions. This handbook is based on the idea that the same is true of the monetary policy choices made by central banks.

As we saw, a change in the view of how monetary policies should be conducted was the main theoretical assumption that led to the adoption of neoliberalism, and that led to a shrinking role for governments in influencing and regulating the economy. Hence, CSOs who want to influence public service financing and raise domestic resources to achieve the SDGs may need to work on monetary policies, and to direct their advocacy towards central banks.

Clearly, a rethinking of the role of monetary policies must consider several aspects, such as the consequences on inflation, exchange rates, inequality, capital flows, and so on. Nevertheless, the range of actions that can be pursued through a different use of monetary policies is very wide. To achieve the SDGs, policymakers should explore the whole spectrum of available policies. The modern world is plagued by large-scale unemployment, climate change, lack of universal healthcare and education, and many other challenges. Are these an acceptable cost to pay for price stability, or equilibrium in the balance of payments? A rethinking of monetary policies and their developmental impact is key to build fairer, inclusive, and more sustainable economic models – especially as the world comes out of the Covid-19 pandemic, while also ensuring a just transition in the face of climate breakdown. For these reasons, we call civil society to reflect on how monetary policies are conducted, and how this can be challenged.

These are some central questions that need to be answered:

- ▶ Should the central banks be independent? Or should they be democratically accountable, and help the government to finance their expenditures, in order to avoid austerity measures?
- ▶ Should tight monetary and fiscal targets prevail, in order to keep inflation low? Or should fiscal targets prevail? Who benefits more from the current monetary policy framework, and how can we change it to benefit the poorest?
- ▶ Should central banks and monetary policies play a role to support a just feminist green transition, and to direct 'the markets' towards more environmentally sustainable practices?
- ▶ Should monetary policies be used by the government to promote poverty reduction and fulfill the right to work

## — Annex 1. Glossary

**Aggregate demand:** an economic measurement of the total amount of demand for all finished goods and services produced in an economy.

**Commodity-driven economy:** an economy which relies on the export of a few primary commodities

**Primary commodities:** commodities produced by the primary sector. This includes any industry involved in the extraction and production of raw materials, such as farming, logging, hunting, fishing, forestry and mining.

**Domestic public debt** is the debt that the government owes to its central bank, local banks and financial institutions, families and companies residing in the country.

**Foreign public debt** is the debt that the government owes to foreign banks and financial institutions

**Full employment:** a situation of very low unemployment, where all available labor resources are being used in the most efficient way possible.

**Price stability:** a situation where prices are stable, due a constant, low level of inflation.

**Real wages:** wages adjusted to inflation.

**Purchasing power:** the value of a currency expressed in terms of the amount of goods or services that one unit of money can buy.

**Exchange rate:** the value of one currency for the purpose of conversion to another

**Depreciation:** a decrease in the value of a currency in a floating exchange system

**Appreciation:** an increase in the value of a currency in a floating exchange system

**Devaluation:** a deliberate decrease of a currency's exchange rate in a fixed exchange rate system

**Revaluation:** a deliberate increase of a currency's exchange rate in a fixed exchange rate system

**GDP—Gross domestic product:** The OECD defines GDP as “the standard measure of the value added created through the production of goods and services in a country during a certain period. As such, it also measures the income earned from that production, or the total amount spent on final goods and services (less imports). While GDP is the single most important indicator to capture economic activity, it falls short of providing a suitable measure of people's material well-being for which alternative indicators may be more appropriate.”

The IMF defines the GDP as “composed of goods and services produced for sale in the market and also includes some nonmarket production, such as defense or education services provided by the government”.

## — Annex 2. Resource section

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7. Mainstream economic principles determine that progress and development ought to be measured purely in terms of economic growth through GDP. Yet, climate activists or feminist economists, for instance, who look at alternatives, argue that this narrow approach fails to acknowledge and address inequalities, planetary boundaries and environmental destruction, and perpetuates the invisibility and undervaluing of women's reproductive role (i.e. unpaid care work is not counted in GDP.) Moreover, GDP is focused on economic growth and is no measure for well-being, gender equality or how growth is being (re)distributed across a population.
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9. Although who has access to loans depends on regulations and oversight. Whether money is invested also depends on rules around the financial market, i.e. in low regulation situations money may not be invested in the productive economy, but in speculative finance (i.e. casino economies).
10. It is important to note, that when people refer to 'the market', 'free market', or 'markets' these are, in itself, specific terms that refer to a model of economics that centers 'productive' activities that formal businesses participate in and capital markets over informal activities, unpaid work and reproductive activities which remain uncounted (see footnote 7). Market fundamentalism is central to neoliberal capitalism and is the belief that free market competition is the most efficient way to distribute resources for production and consumption. This set of neoliberal beliefs or market fundamentalism favours rules, laws and institutions that benefit business and wealth owners (i.e. capital markets) and facilitates the accumulation of wealth and profit, while seeing rules, laws and institutions protecting public goods, human right as 'interventions'. We have thus attempted to highlight this as a term that has certain connotations (and actors behind it who most benefit) within the text by sometimes referring to this as 'the market' or 'markets'. See more [https://www.awid.org/sites/default/files/atoms/files/ccp\\_fullreport\\_eng.pdf](https://www.awid.org/sites/default/files/atoms/files/ccp_fullreport_eng.pdf)
11. The type of taxes matters (and spending). For instance, progressive taxes are less contractionary than regressive taxes.
12. Conversely, consumption taxes tend to be regressive (i.e. VAT), especially when they apply a fixed rate to everyone, or an overall regressive system may lead to exemptions or low taxes on corporations and the wealthiest. When combined with low levels of funding for public services, or public spending which focuses on services/spending which benefits those who are wealthier, this leads to a more regressive fiscal system.
13. See footnote 10 above.
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