Policy discipline from outside?

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This paper provides an economic critique of Ron Duncan’s ‘On achieving sound and stable economic policies in the Pacific islands’, which appeared in the June 1994 issue of the Pacific Economic Bulletin.

Ron Duncan’s article reminds us of the eight policy commandments mentioned by Fischer (1987) and Frenkel (1987) for developing countries.

• Keep budgets under adequate control. Absolute balance may be impossible, but there is not much room for deficits.

• Take advantage of international trade.

• If tariffs are used, keep effective tariff rates uniform. If tariffs become excessive, use export incentives.

• Use price and wage controls sparingly if at all.

• It is rare that quotas, licences and quantitative restrictions are justified. They are inefficient and breed corruption.

• Adopt a technical view of public enterprises. The right criterion is the efficient operation of the enterprise.

• Do not let the exchange rate become overvalued.

• Avoid correcting mistakes by over-reacting.

In the case of the Pacific island countries one could add

• use aid and domestic savings efficiently, concentrating only on investments which yield high returns to the economy

• beware of the power of compound growth in your population figures

• do not abuse the fragile environment

• leave the central bank alone. Let it focus on external and internal financial stability

• allow the private sector to do what it does best.

Let the government focus on

• law and order

• international relations

• sound macroeconomic policies to entrench macroeconomic stability and microeconomic policies for enhancing the
competitiveness of the economy and increasing private investments

- well thought out and carefully appraised public sector investment programs
- human resource development and sound social policies
- implement well-thought out policies firmly and consistently and avoid unjustified backtracking.

The analysis of the current positions, the determination of future development objectives and the formulation of appropriate strategies and policies which the islands should firmly put in place in pursuit of such objectives are relatively easy to do. Numerous economic analyses and accompanying recommendations for island authorities have been carried out by multilateral financial institutions, United Nations bodies, donor countries, academics and island government agencies. But the weakness has always been and will continue to be in the implementation of required policies. Political will is sadly lacking.

Ron Duncan’s observations on the contribution of weak domestic policy to the relatively poor economic performances of the island countries over the last decade, the required policies and the importance of stable policies in entrenching an enabling environment for investment and growth with which we can all agree. In a few short pages, he has encapsulated very well the main development issues with which the islands have to grapple.

Island governments do understand the importance or at least the relevance of incorporating the prescriptions mentioned above, or combinations of them, into coherent strategies which they must have firmly in place. But commitment to policy reform remains weak. As Duncan notes, adjustments and reforms are likely to be introduced when a country experiences serious internal and domestic imbalances stemming from external or domestic shocks or through lax fiscal and monetary policies. The recent case in Papua New Guinea illustrates the point well. In 1989/90, Papua New Guinea went through an economic crisis in the wake of a serious domestic economic shock. Comprehensive stabilisation, adjustment and reform policies were formulated and put in place supported by financial injections from the IMF, IBRD, ADB and AIDAB. But when new mines came on stream accompanied by improvements in the balance of payments, external reserves and revenue receipts, the government’s enthusiasm for policy reform noticeably waned. This development is sad since reforms are more easily implemented, with less political and social costs, during periods of macroeconomic stability and strong economic growth.

Will the islands have the incentive for and commitment to policy reforms? This is the important underlying question posed by Duncan’s article. Ideally of course, strong and enlightened leadership should focus on the required future development path of a country and the needed reforms. It would have a clear strategy for the implementation of such reforms and examine the politics that will inevitably be involved. The chosen strategy will call for a clear understanding of those who will gain and those who will lose in the wake of the reform measures. Public relations will need to be handled carefully and strategic alliances cultivated among the various groups who are expected to gain from the measures. In the islands of course it is very likely that large sections of the community will be unaware of what their positions might be. Government, as part of its public relations exercise, may have to identify groups that will be net gainers, inform them of it and solicit their support for the reform measures. All these of course assume that governments themselves are committed to such measures, an assumption which is subject to debate.
It is conceivable that the manifest lack of enthusiasm for policy reform in the islands is a function of the level of aid flows into the region. Aid underwrites the external sectors and finances the bulk of capital budget expenditures in the island economies. There is still, even now, an expectation in these countries, that aid receipts will continue to grow in real terms, certainly in the medium term. In the past that comfortable scenario enabled island governments to postpone or avoid much-needed policies for adjustment and reform.

Aid poured into a country without appropriate and supportive domestic policy environment for equitable growth will not have the desired impact. So taxpayers in the donor countries, through their governments, must surely have a legitimate interest in insisting that the recipient does what is necessary in a partnership arrangement for promoting self-help. This would of course require discipline and political will by the government of the recipient country.

The Australian Minister for Development Cooperation and Pacific Island Affairs, Gordon Bilney, is sending out the right signals. In a recent statement at the University of New South Wales he said

…the crunch time is rapidly approaching. In this environment, I have made it clear that Australia will not be prepared simply to pick up the bill, and the assistance we do offer must be matched by the implementation of responsible domestic policies by recipient governments.

Ron Duncan shies away from the attachment of conditionality to aid implicit (if not explicit) in Gordon Bilney’s statement. Bilateral relations between governments are certainly sensitive. But it would appear that bilaterals will probably be left with little option apart from announcing steady reductions in aid receipts which would be quite effective in achieving the desired objectives. The conditionality (which I believe bilaterals must consider) need not be as strong as those typically imposed by the Bretton-Woods institutions.

A workable arrangement might require a recipient country to prepare a strategic plan of action as some countries already do. This need not be a lengthy document focusing on broad national and sectoral objectives and policies, macroeconomic policies for entrenching stability, adjustment and reform policies for long-term equitable growth, and well appraised public sector investment programs. Programs of implementation together with target dates would be part of the strategy which should be reviewed say every two or three years. Aid dialogue between the recipient and donor countries should focus more on policies and less on the project list as has tended to be the practice in the past. It would be an understanding between the development partners that performance would be a variable taken into account in determining the level of aid disbursed in the succeeding years. Although the adopted development strategy would have valuable inputs from the donors, it would of course be ‘owned’ by the recipient country. Effective aid coordination within the recipient country and among donors would be a requirement for this scheme of internally formulated and self-imposed discipline to work well. It is a joint development approach, with donors providing assistance to support the recipient’s development efforts of which sound policy framework is an essential and critical component. Much will depend upon the style which the donors adopt during the implementation of this delicate process.

The island countries have limited experience with adjustment and reform programs that are supported by IMF and IBRD finance. Part of the reason for this has already been mentioned. Macroeconomic imbalances generated through external and domestic shocks and fiscal laxity have in
the past been attenuated through aid receipts which the islands are fortunate enough to receive in relative abundance. So apart from Papua New Guinea during this decade and Western Samoa in the early eighties, the Bretton Woods institutions have not had the opportunity to effectively assist in the formulation and implementation of adjustment and reform policies in our part of the world. This shifts the burden for meaningful dialogue to the bilaterals who provide the helpful cushion which to some extent accounts for the policy inertia in the region. Duncan rightfully points out that pressure groups within a country may successfully campaign against aspects of a Bretton Woods institution supported program or that the threat of discontinued drawings of resources from those institutions may not be sufficient disincentives against abandoning policy reform. But it should be noted that a country’s ability to ‘back-track’ on its commitment is a function of its ability to secure alternative sources of financing. Clearly in the islands, in the limited cases where the Bretton Woods institutions might be involved, policy discipline cannot be assured without the active support of the bilaterals.

Ron Duncan has put forward a very interesting proposal in his paper. He suggests that discipline might be imposed upon the islands from outside under another arrangement. The islands might enter into formal economic and trade relationships with Australia and New Zealand. The model that could be adopted is that of NAFTA, with goods and services flowing freely among the member countries. The islands will have to compete on an equal footing with Australia and New Zealand if they are to increase production, investment, trade and economic growth within this arrangement. In order to succeed, domestic macroeconomic policies which address financial stability, and microeconomic policies necessary for promoting competitiveness, investment, private sector growth, and sustainable development will become absolutely necessary. The formal arrangement itself will broadly request such policy commitment from the members and future aid from the developed member countries are to be provided to support the ‘statement of intent’, to borrow IMF jargon, of the island governments.

I agree with Duncan’s observation that economic benefits would accrue to the islands in a Closer Economic and Trading Arrangement with Australia and New Zealand which commits them to policy discipline. From the point of view of Australia and New Zealand the incentives for elevating the depth of their relationship to such an arrangement, as Duncan notes, is not as strong as the incentives of the United States in the case of its relationship with Mexico under NAFTA. Except perhaps for Papua New Guinea, future potential for vigorous trade and investments are, for Australia and New Zealand, marginal in the islands. Asia is where their economic interests are and will continue to be focused in the foreseeable future. The threat of a massive influx across the Rio Grande when economic difficulties emerge in Mexico has no parallel in the Pacific. Duncan feels that moral obligation on the part of Australia and New Zealand will provide the necessary incentive. I am not so sure.

For the islands the incentive for entering into the proposed arrangement is not immediately apparent when other questions which they will inevitably raise are taken into account. Such might include

(i) What are the short-term costs of trade under the proposed reciprocal arrangement, particularly in the light of the rapidly eroding benefits enjoyed under SPARTECA?

(ii) Will Australia and New Zealand declare that future aid transfers will be considered only within the new arrangement?
arrangement? Will islands who opt to remain outside the arrangement be negatively affected under aid?

(iii) If the answers to (ii) are in the affirmative, might not the proposed arrangement be conceived as a subtle mechanism for attaching conditionality to bilateral assistance? If the answers to (ii) are in the negative, can the proposed machinery for externally imposed discipline work?

(iv) What kind of sanctions will be brought to bear upon a member country which reneges upon its policy obligations under the arrangement? Will such sanctions, if provided, take the form of delays in aid disbursements until policy 'performance criteria', to borrow another IMF phrase, are satisfied or will they come, only in the form of stern written or oral expressions of disapproval by the membership?

(v) Will not the same pressure groups which campaign against IMF and IBRD conditionality be equally effective against perceived externally imposed conditions under the proposed Arrangement?

Presumably, a government which shows lack of appetite for policy discipline in the wake of such pressures can as easily opt out of the Arrangement as reneging on the performance criteria of an IMF or IBRD program.

Ron Duncan is to be complimented for his thoughtful proposal which needs to be discussed more widely. Included among the details which should be aired during such discussions are the questions raised above.

References
