

**Standing in the Way of Development?  
A Critical Survey of the IMF's Crisis Response  
in Low-Income Countries**

**ELISA VAN WAEYENBERGE, HANNAH BARGAWI  
AND TERRY MCKINLEY**

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Third World Network

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## **NOTE**

This paper was earlier published in April 2010 as a joint report by Eurodad (the European Network on Debt and Development) and Third World Network in cooperation with the Heinrich Böll Foundation.



## FOREWORD

UNTIL recently, the International Monetary Fund (IMF) was on its way to becoming irrelevant and obsolete. By 2007, it had only one major borrower, Turkey, and thus its revenues had plunged. In October 2007, the Fund attempted to align its payroll with its reduced budget by shrinking its workforce through generous retirement packages. At the same time, the Fund was unable to facilitate effective approaches to counter the growing global imbalance, leaving its supposed role as an ‘international monetary institution’ in question by the international community.

In 2008, the global economic and financial crisis not only restored but also augmented and empowered the IMF’s *raison d’être*. Despite its poor track record in addressing its member countries’ needs in foreseeing the crisis, the IMF was assigned by the G20 major economies grouping with the central role of ‘fire-fighting’ the crisis through financial assistance, which its member countries now desperately needed. Within a matter of months between 2008 and 2009, the IMF experienced the most salient transformation in its history – a massive shift from being an institution fading into obsolescence to the most powerful international financial institution in the global financial architecture and political economy.

The crisis put macroeconomic policy at the centre-stage in political debates about the role of the state, including in the regulation of finance for the public good. Long out of fashion, ‘Keynesian’ approaches such as deficit financing, loose monetary policies and counter-cyclical fiscal stimuli have been embraced once again, as policymakers realise that there are times

when fiscal spending, even at the risk of deficits and debt burdens, can rescue an economy from recession or depression.

Many developing countries assert that the US, where the crisis originated as a result of the American financial markets' reckless approach to market deregulation, has lost its credibility and is no longer in a position to preach the 'Washington Consensus' of privatisation, deregulation and liberalisation in the context of structural adjustment policies. After all, it ignited a massive 'fire' in which the visible hand of the market devastated economies and societies as the most vulnerable groups – the poor and vulnerable and women – were hit the hardest in both the Global North and the South.

Still, almost two years after the crisis started and after trillions of dollars have been spent by governments and taxpayers to bail out the financial sector and the biggest banks in the world, the international community has yet to see a profound and meaningful rethinking of how economic policies should, and could, work for the equitable economic and social development of societies. Indeed, we have not yet witnessed a sea change in the way macroeconomic policies could potentially work for the global and national public good by addressing the increased levels of inequality, poverty and environmental degradation.

The IMF claims that it is implementing significant changes, but the reality is that its institutional dynamics are inflexible. Civil society organisations and external critics challenge that claim. We commissioned this paper in order to subject the Fund's programmes in low-income countries to examination and inform the debate between the IMF and its critics based on empirical evidence. Has the IMF simply tweaked its policy advice or is it undergoing a genuine paradigm shift towards a new Keynesianism? Has the IMF significantly loosened fiscal deficit targets towards embracing genuine counter-cyclical policies? Or has it simply enacted temporary and marginal changes that will revert to business-as-usual once the most severe effects of the crisis subside?

There is an urgent need to identify how countries can most effectively employ macroeconomic policy frameworks to implement equitable

development strategies and poverty reduction. The latter is not new, but to a great extent this debate is confined to academia and is missing from official political circles.

This must change if the international community is serious about reinvigorating progress towards the Millennium Development Goals by 2015. Strong and consistent political will from both institutions and shareholders will be required not only to withdraw from long addictions to neoliberal ideology, but also to address historical structural imbalances and deeply vested institutional interests that are explicitly tied to the unequal distribution of power and wealth predating colonial independence movements. Although the complex issues behind vested institutional interests are beyond the remit of this report, it is a crucial, if not ultimate, precondition for real change.

We should not be led by the claims of the international financial institutions. Rather, we should carry out our own examinations, formulate our own assessments, and assert our own arguments for how and why the macroeconomic policy paradigm of the IMF must change. If it doesn't change as a result of the most cataclysmic crisis and recession since World War II, then when will it?

**Bhumika Muchhala** (*Third World Network*), **Nuria Molina** (*Eurodad*) and **Nancy Alexander** (*Heinrich Böll Foundation*)

## EXECUTIVE SUMMARY

IN an effort to respond to the global financial crisis, the G20 grouping of major economies dramatically strengthened the role of the International Monetary Fund (IMF) in developing countries, including in low-income countries (LICs). To address the urgent financing needs of LICs, the G20 boosted the Fund's concessional lending capacity, which in 2014 will be 10 times higher than before the crisis.

The IMF claims that it has reformed its programmes and provided greater flexibility for LICs to adopt expansionary policies. However, critics of the IMF, including civil society organisations and academics, remain concerned about the persistent rigidity of the policy framework imposed on LICs by IMF lending programmes. Such rigidity will prevent the world's poorest countries from undertaking the necessary counter-cyclical policies during the current global crisis as well as the public investment needed to stimulate long-term growth and development.

This paper assesses the claims by the Fund in the context of its engagement in 13 LICs, with the objective of responding to the following questions:

- Has there been a significant change in IMF programmes in LICs?
- Have the IMF programmes provided sufficient policy space for LICs to address the immediate concerns raised by the global crisis? and
- How does the Fund relate the short-term objective of stabilisation to the long-term objective of growth and poverty reduction?

The report starts with an outline of the IMF's reinvigoration in the aftermath of the global economic and financial crisis (Chapter 1), followed by

a summary of the impact of the crisis in the world's poorest countries (Chapter 2). The report continues with a brief appraisal of the policy framework promoted by the Fund in the context of the crisis (Chapter 3) and a close scrutiny of the Fund's claims of having provided increased flexibility in the design of IMF programmes in the 13 sample countries that received the Fund's financial assistance in 2009 and 2010 (Chapter 4). Chapter 5 presents a broad outline of an alternative framework for macroeconomic policy design. However, rather than providing a blueprint for a new macroeconomic policy design, this framework lays out the scope for alternatives which should remain country-specific. The report ends with a set of recommendations by Eurodad and Third World Network in light of the findings of this research.

### **The impact of the 'twin crises': misfortunes always come in threes**

The combined global food and fuel crisis and the ensuing global financial crisis had grave and far-reaching repercussions for low-income countries. As a result of the crisis, an additional 90 million people will be living in extreme poverty by the end of 2010.

Private investment flows to developing countries fell by more than 40 percent in 2008, and portfolio investment virtually ceased. Across the sample countries, foreign direct investment (FDI) and other private capital flows shrank during 2009, adversely affecting the commodity-exporting sectors in countries such as Tanzania, Ghana, Mozambique, Rwanda and Zambia.

Aid flows have come under threat because of rising fiscal deficits in donor countries. Reductions in official development assistance are a serious concern in recipient countries such as Malawi, Mozambique, Rwanda and Tanzania, where aid finances a substantial share of the national budget.

Workers' remittances were projected to decline as employment conditions worsened throughout the world. In Tajikistan remittances declined by more than 20 percent at the beginning of 2009; and most LICs in sub-Saharan Africa, such as Ethiopia, Ghana and Senegal, have been grappling with similar pressures due to a significant loss of remittance inflows.

In this context, low-income countries face the necessity and the opportunity for a fundamental change of direction in economic policies. Since

the G20 has placed the IMF at the centre of its attempts to deal with the global crisis, it is crucial to assess whether the IMF will rise to this challenge by charting new policy directions or persist in its emphasis on ensuring short-term stabilisation, irrespective of collateral costs.

### **Old habits die hard: new Fund, same old policies?**

This report finds that the Fund's macroeconomic policy design shows the same old set of policy priorities, including low fiscal deficits, low inflation rates, flexible exchange rates, and trade and financial liberalisation.

**With regard to fiscal policy**, of the 13 LICs with IMF programmes examined, fiscal deficit targets increased by less than 2.5 percent of GDP in seven countries. Ghana is a key example of a country that has had to **shrink its fiscal deficits** dramatically, with the IMF saying that the country's fiscal policies need to 'carry the brunt of the adjustment.' In countries such as Benin, Malawi and Zambia, the Fund has also favoured wage and hiring freezes for public-sector workers. However, for the other six countries, more expansionary policies were employed.

Latest IMF projections for the countries assessed show that the fiscal expansion projected for 2009 amounts to only 1.5 percent of GDP on average, and a fiscal tightening of 0.5 percent of GDP is projected for 2010. Eight of the 13 countries are facing tighter fiscal constraints in 2010 than in 2009.

While this suggests greater flexibility compared to the Fund's pre-crisis deficit targets, it is not a significant revision of the IMF's framework. This is problematic because the IMF makes judgements on fiscal policy that take into account the costs of financing a fiscal deficit, but generally fails to factor in the costs of foregone growth and poverty reduction if the widening of the deficit were not allowed. The IMF also fails to assess dynamically the budgetary position of low-income countries, based on the potential for mobilising additional domestic revenue, or for creating greater fiscal space with additional debt relief initiatives or further grant assistance.

Moreover, when fiscal stimulus policies were supported for LICs, they took the form of increases in **current expenditures as opposed to capital**

**expenditures.** Capital expenditures are often programmed to decline, as is the case in Mongolia and Tajikistan where capital investment is projected to shrink by more than 4 percent. While protecting most current expenditures is commendable, deep cuts in capital investment jeopardise the basis for long-term growth and development.

**On monetary policy,** the IMF has continued to push for tightening in countries such as Ethiopia, Ghana, Sierra Leone and Zambia, despite the fact that inflationary pressures are due to the external shocks caused by the food crisis, rather than rising internal demand. Inflation targets for 2008 and 2009 remained firmly within the ‘single-digit’ range. And the Fund’s inflation targets for 2010 have continued on a downward trend. In many countries, this only served to intensify recessionary trends.

The traditional biases of the IMF continue to support macroeconomic frameworks where private interests supersede public interests and the role of the state, where the financial sector takes priority over the productive sector, and where foreign investors and corporate interests override those of domestic actors.

### **Towards growth- and development-oriented macroeconomic policies**

The experience of the ‘Great Recession’ of 2007-09 has altered the terms of the debate on macroeconomic policies. However, the current debate has been mostly limited to advocacy for expansionary (i.e., counter-cyclical) policies without any real debate about the need to emphasise the developmental role of macroeconomic policies, such as the role of deficit financing in countries that are building their nascent social and economic infrastructure.

Previously, the strategic framework of the Millennium Development Goals (MDGs) helped redirect the international debate on macroeconomic policies. By calling for substantial scaling up of external and domestic resources to meet the MDGs, it highlighted the need for more expansionary public-investment-led fiscal policies.

The social outcomes represented by the MDGs need to be made explicit

and taken into account as part of the macroeconomic policymaking process. Fiscal and monetary policies are not neutral, but they entail distributive relations which can either support or hinder the interests of the most vulnerable sectors of society.

Although it is not the intention of this report to provide a new blueprint for macroeconomic policy, it offers a few alternatives which could contribute to long-term equitable growth and poverty eradication. These include:

- Active use of fiscal policy to support public investment to build up essential economic and social infrastructures, on which private investment inevitably relies. Future revenues expected from the investment should pay off the debt that the government initially incurred;
- Ensure adequate money supply to meet the growing demand for money as a result of the growth-induced rise in income. This would imply encouraging low real rates of interest, rather than ineffectively trying to keep inflation low with high interest rates which dampen aggregate demand and growth prospects;
- Manage exchange rates so they can foster broad-based export competitiveness and lead to greater structural diversification of the domestic economy; and
- Regulate the capital account to confront the continuous outflow of domestic private capital from their economies, i.e., ‘capital flight’.

## Conclusions

To sum up, the paper returns to the three initial questions.

**Firstly**, regarding whether there has been significant change in IMF programmes for LICs, the analysis of the latest IMF staff papers and macroeconomic design in 13 LIC programmes shows that **there has been very little fundamental change**.

**Secondly**, with regard to whether the Fund has provided sufficient policy space for LICs to address the crisis, the paper concludes that policy space has not substantially been expanded. Although recent IMF programmes

have indeed allowed for marginally higher deficits during the brunt of the crisis, the relaxation of deficit targets has not only been marginal in size but also proved to be shortlived, as the Fund has already begun advocating tighter fiscal policies starting in 2010. This dynamic has been the same for monetary policy space.

**And thirdly**, on how IMF programmes have related the objective of short-term stabilisation to the longer-term objectives of growth, development and poverty reduction, this paper concludes that Fund policy recommendations, despite declarations of increased flexibility, have remained conditioned by a short-term bias, focused primarily on maintaining price stability. In short, the Fund has failed to move beyond what could be termed ‘Crisis Keynesianism’, and it is already laying the groundwork for reverting to its traditionally restrictive macroeconomic framework.

Unfortunately, such a policy stance remains inconsistent with the compelling need of low-income countries to recover quickly from the impact of the global crisis and accelerate, as soon as feasible, their growth, development and poverty reduction.



## Chapter 1

# THE IMF: THE GREAT WINNER OF THE GLOBAL CRISIS

THE recent attempts by the G20 group of major economies to address the global financial crisis have involved assigning the International Monetary Fund (IMF) a central role. This has led to a renewal and reinvigoration of the IMF's role in low-income countries (LICs) in particular, based on a projected enhanced financing and surveillance role.<sup>1</sup>

In this context, the Fund's concessional lending capacity would be boosted to US\$8 billion over the next two years and enhanced further to US\$17 billion in 2014. These sums represent sizeable increases from its total lending commitments of US\$1.6 billion in 2008 (IMF 2009a, p. 6).<sup>2</sup>

This projected expansion departs from a previous downward trend in the LIC use of IMF facilities, as cumulative disbursements (through all facilities) to these countries fell from 8.1 billion SDRs (Special Drawing Rights) for 1989-93 to 5.8 billion SDRs for 2004-08 (IMF 2009c, p. 11).

Recent volatility and the drying up of liquidity in the global economy has led to a sharp increase in LIC demand for IMF resources, with the number of new financing requests increasing from 5 in 2007 to 23 in 2008 (*ibid.*, p. 12). In the fiscal year 2009, 12 countries received additional assistance under existing Poverty Reduction and Growth Facility (PRGF) lending programmes and 10 new PRGF arrangements were approved (IMF 2009h, p. 52). In total, the IMF approved concessional loans or loan augmentations for 26 countries that amounted to 1.1 billion SDRs (IMF 2009h, p. 25).

This increased availability of IMF resources for LICs has been accompanied by an attempted redesign by the Fund of its 'lending toolkit'. This

redesign claims to make Fund lending more flexible and better tailored to the differentiated needs of LICs (see IMF 2009d). For the IMF, the recent succession of global crises, namely, the food, fuel and financial crises, have represented ‘an unparalleled test of the Fund’s capability to adapt macro-economic policy design to a changing economic environment’ (IMF 2009a, p. 8). The IMF redesign allegedly reconsiders the conditions for access to concessional loans and their financing terms and seeks to modify conditionalities ‘to give countries greater flexibility while supporting macro-critical policies. Conditionality should be tailored to country circumstances and facilities’ (IMF 2009c, p. 6).

Civil society organisations (CSOs), however, remain greatly concerned about the persistently excessive rigidity of the policy framework imposed on LICs by IMF lending programmes, both in general terms and within the context of the recent twin crises – namely, the food and fuel crisis on the one hand and the financial crisis on the other.<sup>3</sup> Such rigidity is very likely to prevent LICs from undertaking the necessary counter-cyclical policies during the current global crisis as well as the public investment needed to stimulate long-term growth and development.

In response to such criticism, the Fund has argued that its lending programmes do indeed provide LICs with sufficient policy space (IMF 2009a). Further, the Fund has contended that it has streamlined and focused its structural conditionalities in accordance with what it calls ‘macro-criticality’. This signifies that structural reforms should now only be included in IMF conditionalities if they are ‘critical to the achievement of macroeconomic stability that is consistent with sustained growth and poverty reduction’ (IMF 2009a, p. 23).

This paper seeks to assess the above claims by the Fund in the context of its engagement with LICs. In this regard, we pose three major questions:

- Firstly, has there been a significant change in IMF programmes in LICs in line with its claims that it has adapted its ‘macroeconomic policy design to a changing economic environment’ (IMF 2009a, p. 8)?
- Secondly, if there has been such a change, have the IMF programmes

provided sufficient policy space for LICs to address the immediate concerns raised by the ‘twin crises’?

- Thirdly, how does the Fund relate the short-run objective of stabilisation to the long-run objective of growth (and poverty reduction)? In this regard, have Fund programmes overcome their traditional and much-criticised short-term bias? This issue becomes particularly pertinent as the initial shocks of the twin crises start to wane and the implications of Fund policies for a transition to ‘medium-term’ growth become important.

Though these issues are far from new, they urgently need revisiting for several reasons: first, an evaluation of the Fund’s own claims of change is needed; second, the new demands placed on macroeconomic policy by the crises require urgent attention; and third, and crucially, the advisability of the strengthened IMF mandate in LICs projected by the G20 needs to be critically assessed.

The starting point for our assessment is a review of the various major documents produced by the IMF during 2009 that address, in general terms, the impact of the crises on LICs and the consequent design of IMF programmes. This general review is complemented by a close scrutiny of the programme documents for a representative set of LICs: Benin, Ethiopia, Ghana, Kyrgyz Republic, Malawi, Mongolia, Mozambique, Rwanda, Senegal, Sierra Leone, Tajikistan, Tanzania and Zambia. (See the appendix for the rationale behind the selection of this sample of countries.)

One of the reasons for selecting these countries is that their programmes differ due to their access to different IMF facilities, such as the PRGF, the Exogenous Shocks Facility (ESF), the Stand-By Arrangement (SBA) and the Fund’s non-financial Policy Support Instrument (PSI).<sup>4</sup>

After this introduction, our paper proceeds as follows. Chapter 2 documents the implications of the ‘twin crises’ for LICs, thereby providing the context within which the recent reinvigoration of the Fund’s role in these countries can be assessed. This is followed, in Chapter 3, by a brief appraisal of the policy framework promoted by the Fund in this context. Chapter 4 closely scrutinises the Fund’s claim of increased flexibility in policy design.

It finds that a short-term and deflationary bias persists in Fund programmes, to the detriment of effective counter-cyclical and long-term development-oriented policies. In other words, the alleged change in Fund policy design appears marginal. This is illustrated with reference to the fiscal and inflation targets in Fund programmes during the crisis.

Finally, in Chapter 5 we present the broad outlines of an alternative framework for macroeconomic policy design that seeks to be more growth- and development-oriented. In this framework, fiscal policy plays the central role, driving the development process primarily through public investment, while monetary policy plays a secondary, primarily accommodating role, ensuring moderately low real rates of interest and an ample supply of credit to stimulate private investment. Rather than providing another blueprint for how macroeconomic policy design should be undertaken, this framework lays out the scope for alternatives, based on the proviso that the particulars of any national macroeconomic programme will remain country-specific.

## Chapter 2

### LICs AND THE 'TWIN CRISES': MISFORTUNES ALWAYS COME IN THREES

THE latest IMF programmes in LICs have been designed against the backdrop of two momentous shocks: the combined global food and fuel crisis and the ensuing global financial crisis. Poor people in poor countries have experienced these crises as a continuum that only added to the structural vulnerabilities that they face. These crises have obviously had grave and far-reaching repercussions for low-income countries and have disproportionately affected poor and vulnerable groups and women.<sup>5</sup>

Through their acceleration of price increases, the food and fuel crises have exacerbated poverty levels, worsened current-account deficits (of food and fuel importers in particular), and substantially raised inflation rates.<sup>6</sup> Among the countries in our sample, Ethiopia, Kyrgyz Republic, Mongolia and Tajikistan saw year-on-year inflation jump to over 20 percent in 2008. Other countries in our sample, such as Benin, Ghana, Mozambique, Senegal, Sierra Leone and Tanzania, experienced more modest increases in year-on-year inflation rates, ranging from 5.8 percent in Senegal to 16.5 percent in Ghana in 2008 (see Chart 5 below).

In some countries, the food and fuel crises caused social unrest and precipitated violent demonstrations, putting governments under considerable pressure to provide relief. Such countries include Mozambique and Senegal in our sample. In this regard, the United Nations Conference on Trade and Development (UNCTAD)'s *Least Developed Countries Report 2008* notes, for example, that 'FAO [UN Food and Agriculture Organisation] simulations using household data from Malawi indicate that a 10 percent increase in food prices leads to a 1.2 percent income loss for the poorest quintile in rural areas

and a 2.6 percent income loss for the poorest urban quintile. According to this analysis, only the richest rural quintile gains from an increase in food prices' (p. 83). Ivanic and Martin (2008) show that in a set of LICs, including our sample countries Malawi and Zambia, the increase in food prices between 2005 and 2007 could have increased poverty by 3 percentage points.

As the food and fuel price shocks began to subside in mid-2008, the global financial crisis began to intensify and spread its impact to the developing world. This crisis has affected LICs through slowdowns in various sources of income: exports, workers' remittances, net private capital flows and official development assistance (ODA). The declines in such sources of income have had a telling effect on constricting the fiscal space of governments in LICs.

### **The impact of the global crises in low-income countries: not so decoupled**

In 2009, global output and global trade are estimated to have fallen by 3 percent and nearly 12 percent, respectively. This is the sharpest downturn in the global economy during the last 60 years (Addison and Tarp 2009). Private investment flows to developing countries – which had peaked in 2007 – fell by more than 40 percent in 2008, as access to international debt markets dried up and portfolio investment virtually ceased (World Bank 2010b). Furthermore, aid flows have come under threat because of rising fiscal deficits in donor countries. Workers' remittances, which had become an important source of foreign exchange, were projected to decline as employment conditions worsened in both the developed and developing countries in which remittances originate.<sup>7</sup> As a consequence of these effects, the World Bank projects that an additional 90 million people will be living in extreme poverty (below US\$1.25 a day) by the end of 2010 (World Bank 2010a).

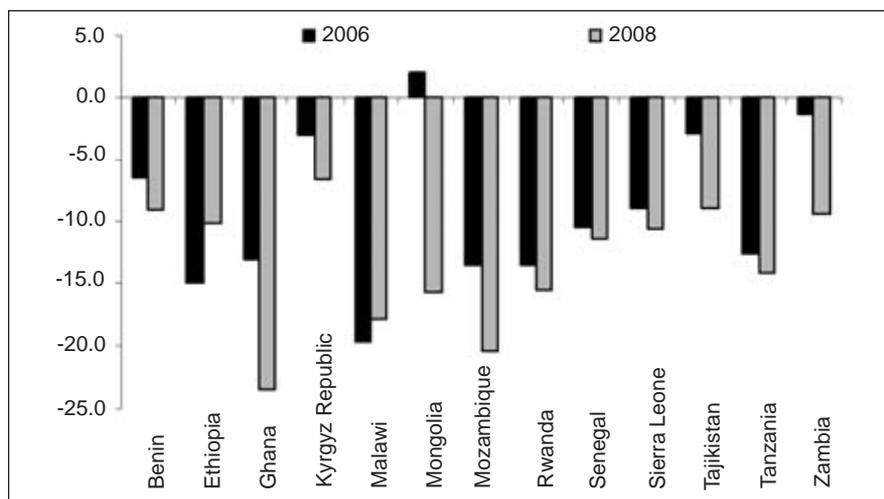
Hence, the transmission channels of the global financial crisis to the developing world have been numerous and diverse. In oil-, mineral- and commodity-dependent countries, which in our sample include Ghana, Mongolia, Mozambique, Tajikistan and Zambia, the reliance on a narrow export base has led to rising current-account deficits as export receipts have

dwindled (see Chart 1). As the most extreme case, Mongolia's current-account deficit turned from a surplus of 2 percent of GDP in 2006 to a deficit of 15.7 percent of GDP in 2008. This kind of loss of revenue has also been accompanied by a decline in incomes and employment in the export sectors of many LICs.

The loss of worker remittances has had significant effects in some of our sample countries. While Tajikistan's remittances had increased dramatically during recent years, reaching over 45 percent of GDP in 2008,<sup>8</sup> they had contracted by January 2009 by 22 percent year-on-year (IMF Country Report for Tajikistan, No. 09/174). LICs in sub-Saharan Africa, such as Ethiopia, Ghana and Senegal in our sample, have been grappling with similar pressures due to a significant loss of remittance inflows.

Across our sample countries, foreign direct investment (FDI) and other private capital flows shrank during 2009 (see Table 1), adversely affecting the commodity-exporting sectors in particular. In Tanzania, for example, US-based Century Aluminium postponed its plans to build a US\$3.5 billion smelter while the Canadian company Xstrata Plc halted plans for a US\$165

**Chart 1: The Impact of the Crisis on Current Accounts**



Source: *IMF Country Documents, various years.*

million nickel mining and extraction plant. Ghana, Mozambique, Rwanda and Zambia experienced similar declines in FDI during 2009. However, it should be noted that the more recent resurgence in commodity prices has been driving a revival in FDI in the extraction and raw material sectors in a number of low-income countries. Going forward, this could open up some additional fiscal space.

**Table 1: The Impact of the Crisis on Inflows of Foreign Direct Investment**

<b>Country</b>	<b>Expected Reduction in FDI between 2008 and 2009 (US\$ million)</b>	<b>Expected Reduction in FDI between 2008 and 2009 (Percentage Change)</b>
Benin	-54.8	-50%
Ethiopia	-10	-1%
Ghana	-128	-12%
Kyrgyz Republic*	-76	-48%
Malawi	-80	-57%
Mongolia	-531	-174%
Mozambique	-55	-10%
Rwanda	-38.4	-59%
Senegal	-4	-5%
Sierra Leone	-19.6	-59%
Tajikistan	-90	-90%
Tanzania	-105	-18%
Zambia*	-245	-36%

\* FDI plus portfolio investments

Source: *IMF Country Documents, various years.*

Since the impact of the ‘Great Recession’ in developed countries has led to rising fiscal deficits and ensuing restrictions on spending, donor agencies are envisaging cutbacks or delays in aid allocations. Despite pledges to the contrary by donors, many LICs are likely to face less predictable aid flows than was the case prior to the crisis. For example, Benin, Mozambique and Zambia have all witnessed shortfalls in donor disbursements over recent months (IMF Country Reports Nos. 09/252, 08/220, 10/17).

**Table 2: Varying Levels of Aid Dependence**

<b>Country</b>	<b>Historical Average Aid to Government Expenditure Ratios (2005-08)</b>
Benin	11%
Ethiopia	19%
Ghana	15%
Kyrgyz Republic	5%
Malawi	38%
Mongolia	1%
Mozambique	32%
Rwanda	41%
Senegal	8%
Sierra Leone	33%
Tajikistan	4%
Tanzania	26%
Zambia	19%

Source: *IMF Country Documents, various years.*

Such reductions are a serious concern in recipient countries such as Malawi, Mozambique, Rwanda and Tanzania, where aid finances a substantial share of the national budget (see Table 2). In our sample, the aid-to-government-expenditure ratio has been as high as 41 percent in Rwanda, 38 percent in Malawi, 32 percent in Mozambique and 26 percent in Tanzania.

Least developed countries (LDCs) are a particularly vulnerable subgroup of the LICs. They are extremely susceptible to the current-account shocks triggered by a slowdown of the world economy, given their weak product diversification and their heavy dependence on external resources to finance development:

‘Volatile prices continue to exert an adverse impact on LDCs’ economic prospects, particularly amongst those specialising in commodity exports. There have been sharp declines in commodity prices since mid-2008. The reliance on commodities as the main source of export and fiscal revenues, along with the strong pro-cyclical nature of commodity prices, contributes to volatility of

output growth in developing countries in general and LDCs in particular.’ (UNCTAD 2009, p. 2).

Given the current fragility of economic recovery in developed countries and the uncertain prospects of the global economy, growth rates and poverty reduction in LDCs are likely to continue being adversely affected. UNCTAD’s *Least Developed Countries Report 2009* notes that:

‘The human and social costs of the present crisis are considerable everywhere, but for the poorest countries, they will include not just the loss of employment but also rising levels of poverty, spreading malnutrition and higher mortality rates for children and other vulnerable groups ... For many LDCs, there is thus a real risk that this economic crisis will turn into a social and humanitarian disaster.’ (p. 6).

### **LICs’ economic policies in the wake of the crisis: a fundamental change of direction?**

A major two-fold challenge confronts most LICs. First, they have to find ways to curb and counteract the fall in domestic demand in their economies in the wake of the ‘Great Recession’; and, second, they have to continue laying the basis for a more secure and sustainable path of growth, development and poverty reduction through structural transformation and diversification of their economies. Hence, the current historical circumstances create both the necessity and the opportunity for a fundamental change of direction in economic policies in the poorer countries of the developing world (UNCTAD 2009, p. 7).

Since the G20 has placed the IMF at the centre of its attempts to deal with the repercussions of the global financial crisis, a vitally important question is whether the IMF will rise to this challenge by charting new policy directions or persist in its emphasis on ensuring short-term stabilisation, irrespective of collateral costs. In other words, will the IMF undertake the meaningful changes in economic policy design that will be needed to help

**Box 1: Roles that the IMF could play in LICs  
in the context of the crises**

- Critical source of balance-of-payments financing
- Catalyst for additional aid flows
- Leader in reconstructing macroeconomic policy design

Will the Fund rise to the challenge?

LICs deal effectively with the impact of the food, fuel and financial crises and achieve the necessary momentum for long-term growth and development?

There are various ways in which the IMF could potentially play a constructive role under current circumstances. The IMF represents a critical source of financing for addressing balance-of-payments disequilibria. The provision of such financial support, without conditionalities, could significantly enhance the ability of borrowing countries to mitigate the negative impacts of the triple crises.

The IMF can also act as a catalyst for releasing additional concessional resources. Facilitating a sizeable and timely inflow of ODA into LICs would create greater fiscal space for financing both current counter-cyclical policies and longer-term growth-conducive public investment. Furthermore, since the global financial crisis has raised serious questions about the validity of many previously held conventional macroeconomic assumptions, the Fund could play an important role in reconstructing macroeconomic policy design, both for supporting concerted counter-cyclical policy interventions and for proactively laying the foundations for sustained growth and poverty reduction.

A recent staff position note by the Fund's chief economist and co-authors, entitled 'Rethinking Macroeconomic Policy', suggests a desire to rise to such challenges. Later in this report we will offer an initial evaluation of its contribution. But the initial indications are that the IMF is prepared to entertain only limited changes in its governing macroeconomic framework – namely, limited changes designed primarily to support immediate responses to the global crisis, such as financing social protection for the poor and strengthening automatic fiscal stabilisers.

## Chapter 3

### THE FUND'S RESPONSE TO THE CRISIS IN LICs

THE IMF's stabilisation programmes have traditionally focused on restoring external balance, where external imbalance is attributed to 'excessive demand' and such demand is understood to originate predominantly in lax fiscal and/or monetary policies. The experience with financial programming – the analytical framework outlining the relationships between policy targets and macroeconomic aggregates in IMF programmes – confirms an excessive IMF focus on, and preoccupation with, the monetary and financial sphere of the economy (the domestic price level, budget deficit, domestic credit and international reserves) rather than, and often to the detriment of, the performance of real variables (real levels of output and income and employment).

'Most of the elements of the pre-crisis consensus, including the major conclusions from macroeconomic theory, still hold. Among them, the ultimate targets remain output and inflation stability.'  
(Blanchard et al. 2010, p. 10).

Macroeconomic design has a crucial impact on the types of development policies low-income countries can or cannot undertake. It also has important distributional impacts – while stringent macroeconomic policies may benefit some sectors of society, such as the financial sector or the creditors, they may have detrimental impacts on others, such as productive sectors, employees, or the poorest of the poor, which cannot benefit from higher growth rates, employment creation or public investment in essential services.

The Fund has often been criticised for imposing overly tight macro-economic policies that are designed to bring about adjustment but often end up undermining growth and poverty reduction. Recently, the Fund itself has referred to ‘concerns ... on the impact of adjustment on public spending (including on government wage bills), restrictive monetary policy, and insufficient financing (failure to perform its [IMF’s] catalytic role satisfactorily)’ (IMF 2009a, p. 8).

Yet, according to the Fund, its lending to LICs has been adapted to reflect the latter’s particular circumstances. Rather than merely aiming to provide ‘temporary balance of payments support to smooth economic adjustment toward a sustainable external position’, the Fund now purportedly recognises that LICs are characterised by entrenched macroeconomic and structural imbalances, with longer-term adjustment needs, and that, as a consequence, adjustment policies need to be reconciled with growth and poverty reduction priorities (IMF 2009c, p. 15).

Hence, while IMF financing for LICs remains focused on macroeconomic stability, it has allegedly been adjusted, mainly in the context of PRGF lending, to reflect the specific, deep-seated problems characterising LICs. According to the Fund (IMF 2009a, p. 8), PRGF-supported programmes have put increased emphasis on ensuring higher budgetary allocations for spending on poverty reduction and more flexible fiscal frameworks to accommodate higher aid flows. Furthermore, some of the most controversial aspects of programme design, such as ceilings on public-sector wage bills, have allegedly been discarded.

The response by the Fund to the current crises provides a timely opportunity to revisit these claims.

### **The IMF in the wake of the crisis: changing or just accommodating?**

Recent IMF documents (IMF 2009e and f) present its understanding of the implications for LICs of the global financial crisis. These documents highlight the dramatic increase in the financing needs of LICs in the wake of the crisis (amounting at least to an additional US\$25 billion, and possibly up to US\$140 billion, in 2009) and emphasise the role of the IMF, both in terms

of its own resources and as a catalyst for further concessional finance.

The IMF recognises that LICs will suffer from reduced demand for their exports and lower remittances and foreign direct investment, and will face the threat of reduced aid flows. The budgetary position of LIC governments is set to worsen, with government revenues expected to decline as economic activity slows and revenues from commodity exports (and thus trade taxes) fall. Such a trend will be exacerbated if donor support declines. The Fund further recognises that, given the economic downturn, efforts to strengthen safety nets to protect the poor become urgent. Finally, the IMF assumed that inflation would drop in 2009 as food and fuel prices declined and demand in the world economy fell (IMF 2009e, p. 5).

Notwithstanding the recognition of these realities, the Fund (IMF 2009e, p. viii) insists that:

‘[c]ountries should focus on macroeconomic stability. In some countries with falling inflation there may be scope for monetary easing; others, however, still experience continued or renewed price pressures. Those with flexible exchange rates should allow them to move, so that they function as shock absorbers. Fixed exchange rate regimes may come under particular pressure owing to the adverse direct impact of the crisis.’

Such an assessment reflects a persistent bias in the way in which the Fund understands its role in LICs, despite claims of having rethought its approach in the context of the crises. More specifically, the IMF’s policy recommendations for LICs’ response to the global financial crisis are as follows (IMF 2009e, pp. 29-34):

Scenarios for fiscal policy in the wake of the crisis are preconditioned by the acceptance of limited access to external finance for LICs, rather than being based on an effort to put forward (and into effect) a strong case for drawing on more external resources. In addition, the IMF rejects the possibility of monetising fiscal deficits in the name of safeguarding macroeconomic stability. An IMF insistence on preserving international reserves indicates its preoccupation with an LIC’s capacity to service or roll over its external

debt. Also, the Fund continues to express concern about the implications of domestic financing of budget deficits ‘crowding out’ private investment, despite such economies being well below full employment. Hence, the IMF asserts that:

‘the space for fiscal easing will depend on the availability of financing from external sources on concessional terms and the scope to raise and use domestic resources in a noninflationary manner, without draining international reserves or crowding out the domestic private sector, as this sector is the main source of long-term growth.’ (IMF 2009e, p. 29).

In effect, such a stance implies the continuing prioritisation of price stability over income stability over the course of the business cycle, of the capacity of LICs to pay off external and domestic debt over the need for further debt relief, and of the projected superiority of the domestic private sector over the public sector in stimulating domestic economic recovery. This seriously limits the ability of LICs to undertake policies that could support growth and development strategies to diversify the economy and enhance resilience to external shocks, employment creation, public investment in essential services, and broader social policies.

The IMF does indeed assert that fiscal space could possibly be created through increasing revenue or reprioritising spending. But given the longer-term nature of achieving the former, the emphasis is on the latter priority. The Fund emphasises that what are labelled ‘unproductive expenditures’ should be reduced, ‘particularly those of a recurring nature’ (IMF 2009e, p. 31). Examples include ‘generalised subsidies, transfers to loss-making enterprises, excessively large government employment, and “white elephant projects”’. In this context, the Fund does not miss the opportunity to reiterate an old priority (p. 31, note 27):

‘This may also be an opportune time to reform domestic pricing mechanisms (e.g. from ad hoc price adjustment systems

to automatic price formulas or price liberalisation) where appropriate.’

Moreover, it states that ‘an important policy priority will be to maintain domestic macroeconomic stability amid deteriorating terms of trade’ (p. 32). And so the Fund argues that:

‘while there may be scope for monetary easing in some countries with falling inflation, countries experiencing continued or renewed price pressures may need to tighten monetary policy.’

Such a course of action to combat inflation is proposed even though the causes of the inflation are recognised to be exogenous and structural.

Finally, for countries with de facto exchange-rate pegs, the Fund advises the introduction of greater exchange-rate flexibility. It strongly discourages countries from resorting to protectionist measures, such as through tariffs or quantitative restrictions on imports, in attempts to ease balance-of-payments pressures (p. 33).

## **2010: back to business as usual?**

An IMF update paper on the implications of the global financial crisis (IMF 2009f, p. 7) revises downward the growth projections for LICs and insists that growth recovery in 2010 will materialise primarily on account of further and increased openness to trade and foreign capital, as this will ‘enable the private sector to take better advantage of rising world demand’, ignoring the fact that private capital flows for LICs are projected to dwindle close to zero in 2010 (World Bank 2010a). LICs will need to increase efforts, the paper asserts, to reform and ‘modernise’ their economies in the post-crisis environment. This will entail a host of measures, including:

‘[m]easures to improve the business environment, develop well-regulated local capital markets and banking systems, and

enhance efficiency in the public sector ... Barriers to trade ... should be brought down, and resources channelled to addressing the serious “infrastructure deficits” that most LICs face. These efforts will require strong financial and technical support from the international community, long after the present crisis is over.’ (IMF 2009f, p. 27).

The above statements suggest a continuing firm IMF commitment to a set of policy priorities. These include low fiscal deficits, low inflation rates, flexible exchange rates, and trade and financial liberalisation. Such policy recommendations persist in failing to derive policy propositions from the realities of less developed countries, in which economies tend to be demand-constrained rather than operating close to full employment capacity and in which various structural bottlenecks, rather than ‘price incentives’, inhibit supply responses (see Chapter 5 below).

#### **Box 2: A deflationary stance continued?**

The Fund’s macroeconomic policy recommendations in the wake of the crises have tended to be characterised by:

- Fiscal rectitude
- Rejection of monetising deficits
- Preoccupation with an LIC’s capacity to service debt
- Emphasis on the dangers of crowding out
- Proclivity to cut government subsidies
- Liberalisation of prices
- Tight monetary policy
- Exchange-rate flexibility
- Further dismantling of ‘barriers to trade’
- Precautionary reserve accumulation

### **Why macroeconomic policy design matters for the poor**

There is insufficient appreciation of how the macroeconomic policy framework sets the terms on which social policies can be undertaken. The

latter cannot be treated in isolation: they are conditioned by the nature of the macroeconomic framework. Such an oversight pervades the Poverty Reduction Strategy approach, which often seeks to open up social policy design to broad discussion and popular participation while insisting on predetermining the governing macroeconomic framework. Such an approach relegates social policy to the status of an add-on. Elson and Cagatay (2000, p. 1347, original emphasis) sum up this approach nicely:

‘Although there is now widespread recognition of the need to integrate macroeconomic management and “social policies”, there is still a strong tendency to think this means continuing to design what are termed “sound” macroeconomic policies with a focus on market-based criteria, an overriding emphasis on stabilising the price level and reducing the role of the state, and then *adding* social policies in order to achieve socially desirable outcomes such as poverty reduction. An alternative approach to considering social policies as an afterthought to macroeconomic policies would start with the premise that all macroeconomic policies are enacted with a certain set of distributive relations and institutional structures; and that all macroeconomic policies entail a variety of social outcomes which need to be made explicit.’

The soundness of any set of macroeconomic policies needs to be judged in terms of the scope it creates for accelerating growth and reducing poverty, rather than on the basis of adhering *a priori* to a set of market-based criteria. Moreover, rather than being concerned merely with the social impact of macroeconomic policy (‘after the fact’), the underlying social content of such policy, i.e., the social power that drives a particular macroeconomic policy, needs to be recognised and assessed (Elson and Cagatay 2000). In essence, the distributive equity of any single economic measure needs to determine whether or not the measure ought to be implemented, rather than being ameliorated after the measure has produced inequitable results.

In other words, the types of policies advocated by the Fund have sought to enhance the expansion of private interests over public interests, prioritised the interests of the financial sector over the productive sectors of the economy, and favoured foreign corporate interests over domestic ones. The approach espoused and promoted by the IMF has often been depicted as an explicit reflection of the deeply asymmetrical governance structure of the IMF, where the US holds veto power in the decision-making body and where European countries alone constitute almost a third of the voting power of 186 member countries. The vested political interests of the developed countries that govern the economic prescriptions of the Fund have, over the last 30 years, implied the persistent promotion, through both state and market mechanisms, of private interests in general, and finance in particular. Saad-Filho (2010, p. 10) comments:

‘It is apparent that this combination of policies, regulations and incentives [as subsumed under the Washington Consensus] is designed to reduce the economic role of state institutions, and transfer to the (financial) markets control over the allocation of economic resources, including the levels of investment and consumption, the allocation of investment funds, the composition of output and employment, and the selection of the country’s competitive advantages. In these circumstances, poverty alleviation cannot be a priority except rhetorically.’

Such a political-economy approach becomes essential to understanding how to challenge and change IMF policies. While acknowledging that such issues are of paramount importance, we confine our attention in this paper to a direct critical assessment of the content of IMF macroeconomic policies.

## Chapter 4

# OLD HABITS DIE HARD: NEW FUND, SAME OLD POLICIES?

DESPITE the Fund's continuing commitment to a restrictive, if not deflationary, macroeconomic framework, which is ill-designed to address the consequences of the global crisis for low-income countries and ill-prepared to support long-term growth and development, the Fund has insisted that its recently approved LIC programmes have exhibited considerable flexibility and provided expanded policy space in the face of the food, fuel and financial crises (IMF 2009a, p. 4).

In support of this argument, the recent IMF paper, 'Creating Policy Space – Responsive Design and Streamlined Conditionality in Recent Low-Income Country Programs' (IMF 2009a), has sought to document explicitly how Fund programmes in a representative sample of LICs have been responsive to current priorities. This sample includes LICs that had continuous programme engagement with the Fund under the Poverty Reduction and Growth Facility between January 2007 and June 2009. It includes: Afghanistan, Albania, Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, The Gambia, Haiti, Kyrgyz Republic, Malawi, Mali, Niger, Rwanda, Sierra Leone and Zambia.

We compare the findings of this report with the experience of the countries in our own sample, which includes six countries present in the Fund's sample (Benin, Kyrgyz Republic, Malawi, Rwanda, Sierra Leone and Zambia) as well as other countries that have engaged with the IMF recently on terms beyond the PRGF framework (Ethiopia, Ghana,<sup>9</sup> Mongolia, Mozambique, Senegal, Tajikistan and Tanzania).

## Creating policy space?

In ‘Creating Policy Space’ (IMF 2009a), the Fund explains that two principles guided its ‘strategic approach’ to the crisis. The principle of ‘balance between adjustment and accommodation’ was combined with the principle of ‘starting conditions’ or country-specificity. However, the principle of ‘balance’ reflects the Fund’s persistent commitment to (and bias in favour of) macroeconomic stability through maintaining small fiscal deficits and low inflation rates (p. 9):

‘While it is critical to preserve hard-won macroeconomic stability gains by avoiding high inflation and ensuring sustainable fiscal and external debt in the medium term, macroeconomic policies should, to the greatest extent possible, sustain short-term activity and protect the poor by accommodating the increased financing needs.’

The Fund recognises that some countries entered the crisis with ‘better’ macroeconomic positions than others, and here the principle of ‘country-specificity’ comes into play (p. 9):

‘On the whole, LICs went into the storms of the twin crises in a much stronger position than ever before ... inflation had been brought down to single digits. Government finances were strengthened considerably, with improved fiscal balances and sharply lower levels of public debt ... Foreign reserves had increased substantially ... [Yet] some LICs continued to exhibit high inflation, large deficits and low reserves.’

Purportedly avoiding a ‘one-size-fits-all’ approach, the IMF followed these two principles in recommending ‘different’ strategies for individual LICs. To a certain extent, this is true since the IMF claims to have identified varying debt and fiscal constraints in different countries and determined its support for sustaining short-term economic activity accordingly.

In our sample countries, for example, a number of countries were in a relatively strong fiscal position prior to the crisis. Benin, Kyrgyz Republic, Mongolia, Rwanda and Zambia displayed small surpluses or marginal deficits in the run-up to the current crisis.<sup>10</sup> Other sample countries, particularly Ghana and Tanzania, experienced worse fiscal positions prior to the crisis (see Table 3).

Similarly, international reserve levels, as measured by the months of coverage of imports, varied significantly across our sample countries prior to the crisis (see Table 4). While Benin, Mozambique, Rwanda and Tanzania were in relatively good positions, Tajikistan and Malawi had reserves that covered less than two months of imports during 2005-07.

Chart 2 depicts the diverse positions of our sample countries with regard to both domestic and external public debt. Having benefited from debt relief through the Heavily Indebted Poor Countries (HIPC) initiative and more recently the Multilateral Debt Relief Initiative (MDRI), a number of our sample countries had seen their external debt fall to less than 40 percent of GDP by 2007. Some countries, such as Benin, Ethiopia, Malawi,

**Table 3: Pre-Crisis Fiscal Balances Including Grants**

<b>Country</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Benin	-2.5	-0.5	1.6
Ethiopia*	-4.4	-3.9	-3.1
Ghana	-3.0	-7.5	-9.2
Kyrgyz Republic	-2.2	-1.2	0.3
Malawi	-1.5	-0.7	-3.1
Mongolia	2.6	8.2	2.8
Mozambique	-2.2	-1.5	-3.8
Rwanda	0.7	-0.4	-1.5
Senegal	-3.0	-5.7	-3.7
Sierra Leone	-2.7	9.3	-2.0
Tajikistan	-2.4	2.9	-5.1
Tanzania*	-4.2	-6.1	-5.0
Zambia	-2.6	18.6	-0.2

\*Fiscal Years - 2006/07 = 2007

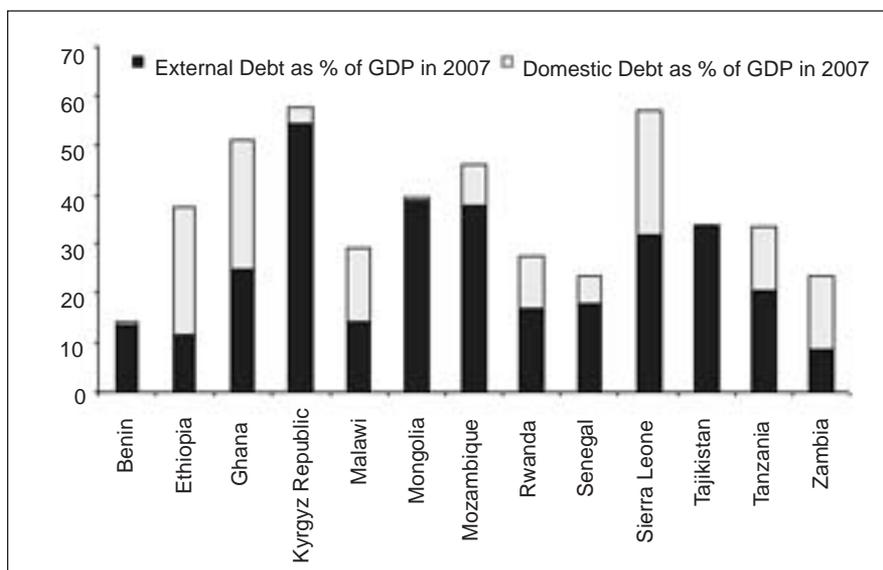
Source: *IMF Country Documents, various years.*

Table 4: **Pre-Crisis International Reserve Positions**

Country	Average International Reserves in Months of Imports (2005-07)
Benin	6.9
Ethiopia	2.5
Ghana	2.8
Kyrgyz Republic	3.1
Malawi	1.3
Mongolia	2.9
Mozambique	4.6
Rwanda	5.7
Senegal	3.2
Sierra Leone	4.3
Tajikistan	0.7
Tanzania	4.6
Zambia	2.1

Source: *IMF Country Documents, various years.*

Chart 2: **Pre-Crisis Public Debt Positions**



Note: No domestic debt data for Tajikistan is available.

Source: *IMF Country Documents, various years.*

Rwanda, Senegal, Tanzania and Zambia, had levels of external debt below 20 percent of GDP by 2007. The Kyrgyz Republic is a notable exception. Not having benefited from the MDRI, its external debt in 2007 was well over 50 percent of GDP.

Following its principles of ‘balance’ and ‘country-specificity’, the IMF has generally recommended that countries respond to the crisis as follows (p. 9):

‘Where fiscal and external debt sustainability was not at risk, countries were advised to allow larger fiscal and current account deficits ... In LICs with highly vulnerable debt and binding fiscal constraints, the Fund has advised the reprioritisation of resources needed to protect social and other core spending.’

While this approach translated into the revision of inflation targets upward during the food and fuel crisis, it also led to downward revisions after these prices receded. The IMF advocated some ‘fiscal easing’ but this typically involved letting the automatic stabiliser of falling government revenue lead to increases in private expenditures. The IMF also allowed some limited margin for spending increases.<sup>11</sup> According to the Fund, close to two-thirds of the fiscal targets for its sample countries accommodated increases in government spending, primarily because they were encouraged to safeguard social protection. Countries with more vulnerable debt positions were urged to adopt a cautious fiscal stance, but the Fund argues that even in these cases, IMF programmes typically provided for a widening fiscal deficit in 2009 (IMF 2009a, pp. 12-21).

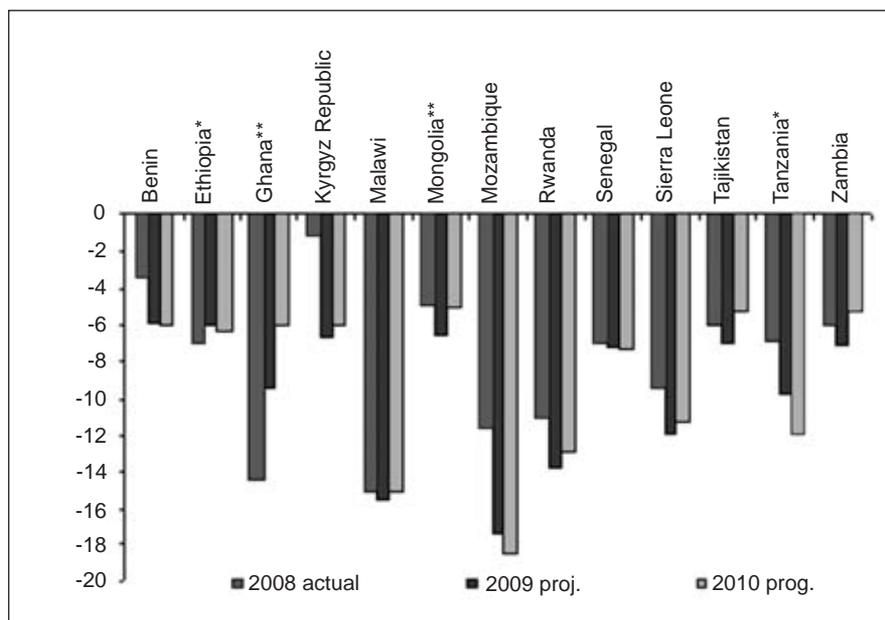
However, for those countries in the Fund’s sample that implemented a discretionary fiscal stimulus, the Fund insisted that this expenditure would need to be wound down by 2010 in order to ensure fiscal consolidation (IMF 2009f, p. 9). The expenditure rationalisation needed to achieve this objective is expected to focus ‘mainly on current expenditures, including the wage bill, transfers and subsidies’ (p. 9).

In our own sample of countries, the IMF did appear to accept the

principle that further fiscal retrenchment during the crisis could jeopardise social and development objectives. Using the measure of fiscal balances before grants, we note some increase in programmed deficits for 2009 in the majority of countries, compared to those for 2008 (see Chart 3).

Frequently, the expansion of fiscal deficits was supported by the Fund on the condition that the additional spending was directed to priority (often poverty-related) areas. In Zambia, the IMF outlined that ‘non-priority spending will be constrained in preference for spending aimed at stimulating growth, diversifying the economy and better targeting support to vulnerable groups’ (IMF Country Report for Zambia, No. 10/17, p. 79). In Tajikistan the Fund noted that the authorities ‘have committed to raising transfers to households in response to the economic crisis, and increasing resource

**Chart 3: Programmed Fiscal Balances Excluding Grants (% of GDP)**



\* Fiscal Years 2006/07 = 2007

\*\* No data on fiscal deficits excluding grants are available. The figures for Ghana and Mongolia therefore include grants.

Source: *IMF Country Documents, various years.*

allocations for health and education.... To achieve their overall deficit target, the authorities are delaying some low-priority investment projects and scrutinising current expenditures carefully' (IMF Country Report for Tajikistan, No. 09/174, p. 109). In Senegal, Tanzania and Benin, the Fund supported spending increases on short-term, targeted safety nets such as school feeding programmes and temporary price support systems.

However, to refer to this approach as evidence of an expansion of 'policy space', as claimed by the IMF, indicates a lack of imagination, or misconstruing (if not hijacking) of the meaning and practice of policy space – a term traditionally associated with those advocates of a policy regime prioritising a longer-term and more development-oriented perspective.

We illustrate this major point in the context of both fiscal policy and inflation targeting. We find that fiscal policy has remained largely subservient to inflation-targeting monetary policies, and that proclivities towards monetary tightening continue to prevail in many LICs. This condition prevails despite the fact that inflation is being driven mainly by structural bottlenecks or external factors. The Fund has allowed only modest widening of fiscal deficits as a means to counteract the impact of the 'Great Recession'. Furthermore, it has failed to rise to the challenge of playing a catalytic role in mobilising additional grant assistance or debt relief that could adequately finance a widening of fiscal deficits.

### **The Fund and fiscal policy during the crisis**

Close examination of IMF programmes suggests that the revisions of macroeconomic targets in the wake of the crisis were marginal. For example, among the LICs in the Fund's own sample, fiscal deficit targets of -1.5 percent of GDP, on average, were initially projected for the 2007 programmes. These were revised to about -2.5 percent in the 2008 programmes, and then to about -3.7 percent in the 2009 programme. But the programmed deficits subsequently dropped back down to below -3 percent of GDP in the projections for 2010 (IMF 2009a, p. 17, Figure 5). However, the latest IMF projections for our sample countries are quite different. For example, the fiscal expansion projected for 2009 is only -1.5 percent of

GDP on average and a fiscal tightening of 0.5 percent of GDP on average is projected for 2010 (see Chart 3).

In this respect, the Fund's claims for allowing greater policy space make sense only in relationship to its previous programme targets. The Fund's alleged flexibility is based on accommodating marginal adjustments to initially restrictive recommendations. The underlying macroeconomic framework, and its attendant biases, has remained essentially intact. Part of the problem is how the IMF conceptualises the supposed 'balance' between adjustment and accommodation.

Among our own sample countries, Ghana stands out as a country that has had to shrink its fiscal deficits (after grants) dramatically. Ghana's fiscal deficit was brought down radically in 2009, with the IMF stating that the fiscal side needed to 'carry the brunt of the adjustment' (IMF Public Information Notice for Ghana, No. 08/84). This signified major expenditure cuts. Despite the adverse impact of the global economic crisis on the Ghanaian economy, fiscal authorities 'have cut tax exemptions, identified wage savings, and are adopting a temporary profit tax surcharge' (IMF Country Report for Ghana, No. 09/256, p. 6).

In those cases where the IMF appears to have allowed fiscal deficits to widen, the endorsed increase has not only been relatively moderate, but also restricted to the short term. For seven of the 13 countries in our sample, the IMF targeted an increase of fiscal deficits of less than 2.5 percent of GDP in 2009. Moreover, as shown by Chart 3 above, the majority of countries in our sample are facing tighter fiscal constraints in 2010 than those in 2009.

The Fund's rationale for allowing marginal temporary increases in the fiscal deficits in Senegal and Benin is illustrative of its general stance. For Senegal, the IMF states that: '[w]hile the authorities reiterated their commitment to a fiscal policy that would keep debt sustainable over the medium term, moderate short-run fiscal expansion in late 2009 and 2010 could support aggregate demand, as growth is still sluggish' (IMF Country Report for Senegal, No. 10/13, p. 14). For Benin, the IMF supports the use of automatic fiscal stabilisers in tackling the crisis and insists that: '[w]ith limited absorptive and administrative capacity, a larger fiscal expansion could compromise macroeconomic stability and fiscal and debt

sustainability, with only limited benefits for growth' (IMF Country Report for Benin, No. 09/252, p. 14).

In our sample of countries, just a few countries, such as the Kyrgyz Republic, Mozambique, Rwanda and Tanzania, have been programmed to widen their deficits substantially in order to cushion the impact of the global downturn. Moreover, in our sample, Tanzania is the only country that has an explicit economic rescue package supported by the Fund. As part of this package, the Tanzanian authorities, with the Fund's support, have introduced input subsidies and price-support instruments in the agricultural sector, as well as temporary tax exemptions and reductions. But the resultant noteworthy increase in Tanzania's fiscal deficit before grants of almost 5 percent of GDP between 2008 and 2010 is expected to be partially financed by additional donor assistance (IMF Country Report for Tanzania, No. 09/336).

However, the IMF's Tanzanian approach can act as a starting point for discussing the limits of its approach. Judgements about the desirability of a country's particular fiscal stance need to take into account not only the costs of financing a fiscal deficit but also the costs of foregone growth and poverty reduction if the widening of the deficit were not allowed. Instead of restricting donor assistance because of unprogrammed increases in fiscal deficits, the IMF should concentrate on proactively eliciting donor assistance in order to finance the widening of deficits to accommodate expenditures that can either counteract recession or support a long-term growth process.

In other words, the budgetary position of an LIC needs to be assessed dynamically, based on the potential for mobilising additional domestic revenue and eliciting the funding of government debt from domestic financial sources. Efforts should also be mounted to determine the degree of fiscal space that could be created by supporting additional debt relief initiatives or enlisting further grant assistance.

In this context, Saad-Filho (2010, p. 24) calls for a stance of 'constructive ambiguity' with respect to macroeconomic stability, so that stability is pursued because of its instrumental value rather than as a set of pre-defined arbitrary restrictions imposed on government action on the basis of maintaining restrictive targets on inflation rates and fiscal deficits.

The implication is not that stability is unimportant, but that it should not become an end in itself. Moreover, the costs associated with macroeconomic strategies fixated on achieving price stability should be recognised and assessed against alternative policy stances that prioritise more rapid growth and poverty reduction.

Further, in assessing the Fund's interpretation of 'fiscal space', it is important to differentiate between the operation of automatic stabilisers and the use of discretionary counter-cyclical fiscal policies.<sup>12</sup> Incurring a worsened deficit position does not in itself indicate that discretionary policies are being enacted (see Weisbrot 2009). For example, IMF (2009f, p. 19) informs us that only one-third of all LICs engaged in discretionary fiscal policy in response to the crisis.

Moreover, IMF (2009a) notes that for its sample countries, government spending targets have not been, on average, adjusted upward since the projections that were part of the 2007 IMF programmes. However, in the 2009 programmes, spending targets have already been adjusted downward for 2010, since economic recovery is expected to start and fiscal adjustment to 'kick in' (p. 18). A number of countries in our sample, including Benin, Malawi, Mongolia, Tajikistan and Zambia, have already been under pressure from the Fund to cut specific elements of their budgets.

In Mongolia, the IMF has strongly advised the government to reform its child money programme. In the wake of the global crisis, decreasing copper prices slashed one of the main sources of financial support for the Mongolian welfare system. Hence, the Fund advised the government to target these benefits to the poorest children, to prevent further pressure on the government's fiscal deficit. However, in a country with weak statistical capacities to accurately identify the poorest sectors of society and where almost two-thirds of the country's children are poor, targeting the poorest may be easier in principle than in practice.

IMF (2009f) also indicates that when fiscal stimuli were endorsed for LICs, they took the form of increases in current expenditures, not capital expenditures. This contrasts with the experience of the developed countries (as well as some emerging economies), where the fiscal stimulus has often been oriented to capital spending. While it is commendable that the Fund

supports social spending in response to the financial crisis, it rarely appears to prioritise capital expenditures.

Often, public investment is programmed to decline, jeopardising the basis for long-term growth and development. In Mongolia and Tajikistan, for example, capital investment is set to shrink, from 10.4 percent of GDP in 2008 to 6.7 percent in 2010 in Mongolia and from 14.1 percent of GDP in 2007 to 10.6 percent in 2009 in Tajikistan (IMF Country Reports).

In addition, the Fund frequently contradicts its endorsement of protecting social spending by cutting consumer subsidies and raising the domestic prices of food and fuel. In Malawi, for instance, the Fund supported the pass-through of international fuel prices to the domestic economy, which ‘is equivalent to a 1½ - 2 percent decline in household real disposable income’ (IMF Country Report for Malawi, No. 09/16, p. 11). The IMF has supported an analogous pass-through of international fuel prices in Benin and Sierra Leone (IMF Country Report for Benin, No. 09/252 and IMF Country Report for Sierra Leone, No. 09/256). Although the Fund claims that it only advises cutting consumer subsidies where a particular input is not consumed by the poor, cutting fuel subsidies in Ethiopia immediately increased the price of kerosene, which is the usual source of energy for cooking in the poorest households. Such a measure has had a dramatic impact on access to energy and food safety for the poorest Ethiopians in the wake of the food and fuel crisis.<sup>13</sup>

At the same time, the Fund has favoured wage and hiring freezes for public-sector workers in countries such as Benin, Malawi and Zambia. In Zambia the IMF states that: ‘[t]he upward trend in the wage bill needs to be reversed to free resources for other priority outlays and social spending’ (IMF Country Report for Zambia, No. 10/17, p. 73). In Benin the Fund is recommending ‘a comprehensive reform of the civil service, in order to improve the functioning of public services, contain the public wage bill, and preserve the financial viability of the civil service pension fund’ (IMF Country Report for Benin, No. 09/252, p. 11).

In supporting the reining in of fiscal deficits in some LICs, the IMF has focused heavily on cuts in expenditure, through reductions in alleged non-priority spending. IMF-supported measures to raise domestic revenue

remain of secondary concern. Where domestic revenue mobilisation has been advocated, it has tended to rely on regressive policy choices, with a focus on increasing value-added taxes or other forms of indirect taxation. In Sierra Leone, for example, the Fund is promoting the introduction of a General Sales Tax (GST) while in the Kyrgyz Republic it is advocating an increase in the age for pensions in order to safeguard tax revenues.

Zambia is an exception to the above picture. In this case the IMF has supported the introduction of a tax on mining companies. The Fund reports that '[f]iscal policy in 2010 retains the focus on harnessing domestically-generated resources to support the diversification of the economy' (IMF Country Report for Zambia, No. 10/17, p. 4). However, these measures follow a long history of IMF pressure to privatise the mining sector in Zambia, liberalise investment regimes, and grant extremely favourable tax regimes to foreign companies which dramatically limited the government's ability to raise revenues from its extractive sector. In the wake of the hike in commodity prices in the mid-2000s, the Zambian government pushed strongly to increase taxes on the mining companies and the Fund finally accepted the government's decision. Unfortunately, the current focus on domestic revenue mobilisation in Zambia does not appear to be translated into similar initiatives in other LICs, where such pressure from government and civil society organisations has not been as forthcoming.

Some IMF programmes have approved financing additional public spending with increased aid inflows. But eliciting such external assistance remains dependent on the IMF's own assessment of a country's performance. Hence, countries such as Ethiopia, Malawi and Tanzania, which the IMF regards as 'good performers', have benefited from additional aid inflows.

However, Tajikistan's experience represents a contrast. The European Union (EU), Asian Development Bank (AsDB) and World Bank temporarily halted their lending operations in Tajikistan in order to await the outcome of a Staff Monitored Programme with the IMF (IMF Country Report for Tajikistan, No. 09/174). A similar picture emerged in Senegal, for which 'the authorities [were urged] to implement their action plan and agree with staff on strong commitments to bring the program back on track. This would unfreeze budget support from several donors, including France, the

Netherlands, and the African Development Bank’ (IMF Country Report for Senegal, No. 09/5, p. 13).

Finally, the IMF raises concerns about the debt sustainability of current macroeconomic policies in low-income countries (see IMF 2009e, p. 25), but such concerns are used primarily to justify stringent ceilings on government expenditures instead of serving as a basis to press for additional relief for LIC external debts.

**Box 3: The Fund and fiscal policy in LICs during the crises: the evidence**

- Marginal widening of fiscal deficits
- Short-term commitment to widening fiscal deficits
- Fiscal policies confined to non-discretionary automatic stabilisers
- Failure to prioritise capital expenditures
- Priority on cutting consumer subsidies
- Insufficient priority to enhancing domestic resource mobilisation
- Insufficient advocacy of a scaling up of ODA
- Insufficient advocacy of further debt relief

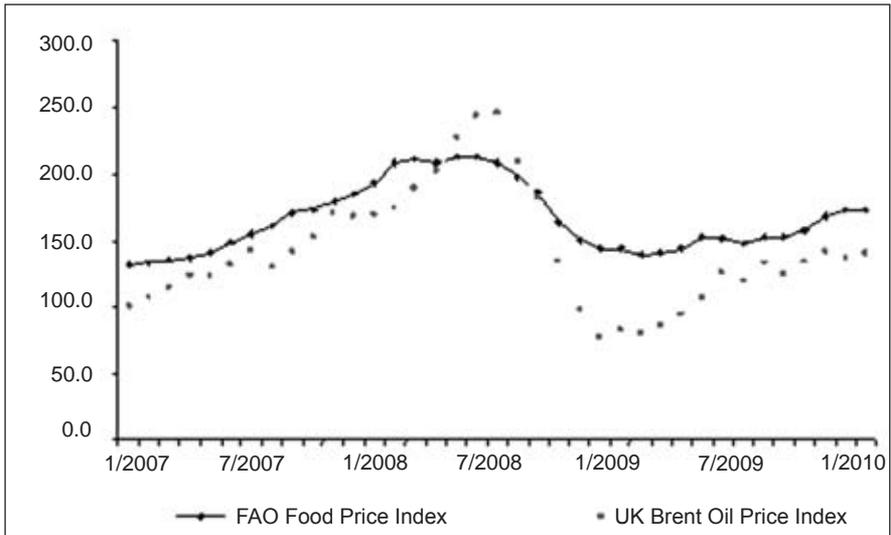
### **Inflation targeting in crisis programmes**

With regard to inflation, the Fund has also demonstrated only a limited degree of flexibility. For example, among the Fund’s sample of countries (IMF 2009a, p. 16), the revised inflation targets for 2008 and 2009 remained firmly within the ‘single-digit’ range.

Across our sample of countries, increases in food and fuel prices over 2007-08 accounted for much of the increase in inflation rates at that time. The rising cost of these items over the course of 2007 and the beginning of 2008 is revealed by Chart 4. This is paralleled by rising CPI (Consumer Price Index) inflation rates between 2007 and 2008 for our sample countries in Chart 5. While the IMF has acknowledged this reality, its advice on tightening domestic monetary policies has not been consistent with such an understanding.

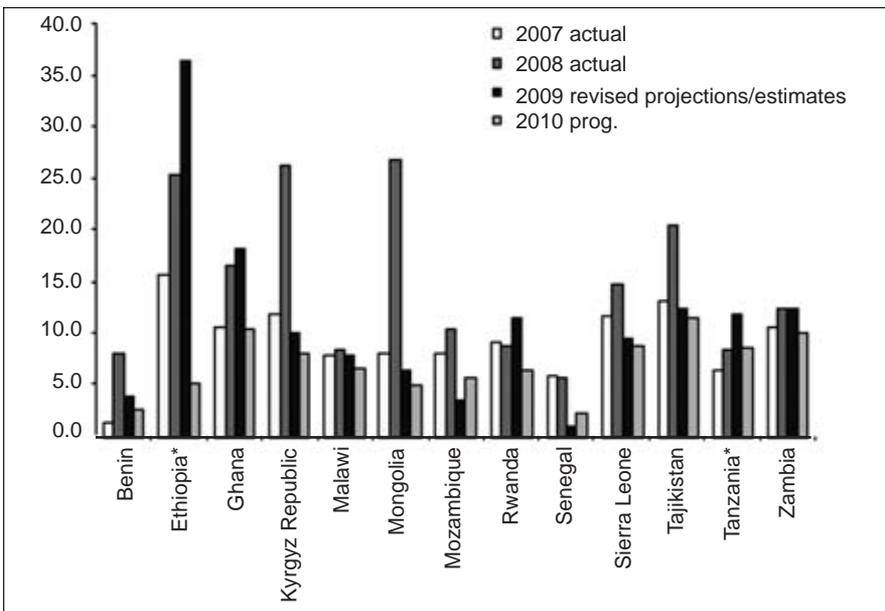
International food and fuel prices subsided sharply in the latter half of 2008 and early 2009 (see Chart 4). This sudden and sharp fall can partially

**Chart 4: Food and Oil Prices (2007-10)**



Sources: **FAO**, <http://www.fao.org/worldfoodsituation/FoodPricesIndex/en/>, 2002-04=100; **IMF International Financial Statistics**, UK Brent Oil Prices, 2005=100

**Chart 5: IMF Projections and Targets for Consumer Prices (Average)**



\* Fiscal Years - 2006/07 = 2007

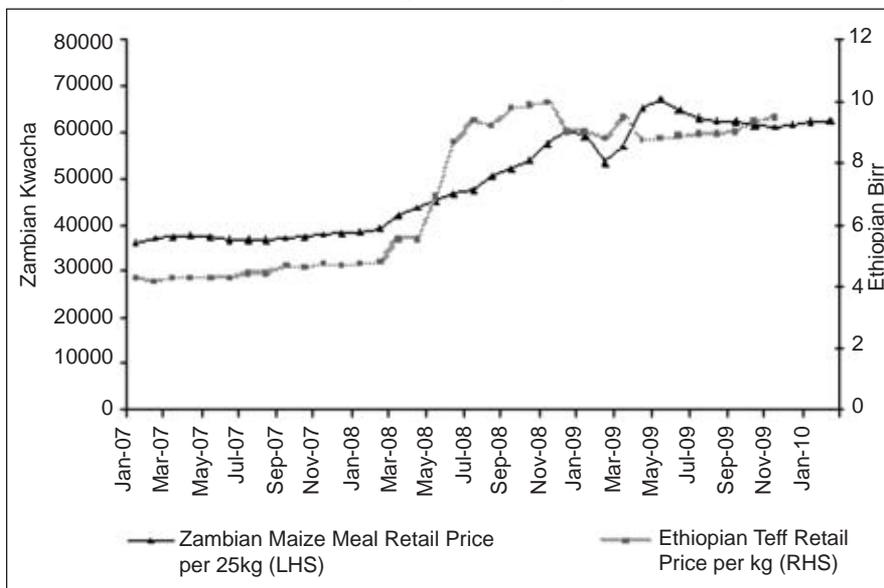
Source: **IMF Country Documents**, various years.

explain the lower projections by the IMF for inflation rates in 2009. However, since mid-2009 food prices have begun to creep upwards again. Yet, despite these latest increases, the Fund's inflation targets for 2010 have continued on a downward trend. In other words, inflation trends and IMF inflation targets often diverge.

The IMF has continued to push for monetary tightening in countries such as Ethiopia, Ghana, Sierra Leone and Zambia. However, a closer consideration of the retail prices of the main food staples in these countries reveals an almost continuous rise in prices over 2008 and 2009 (see Chart 6). Far from subsiding, inflationary pressures caused by food price increases have continued to be a major challenge for many LICs.

In a few cases, the IMF has recognised that continued monetary tightening might hamper economic recovery. Mozambique and Tanzania

**Chart 6: Food Prices for Main Staples in Ethiopia and Zambia**



Sources: **Ethiopian Central Statistics Agency**, <http://www.csa.gov.et/>; and **Zambian Central Statistics Office**, <http://www.zamstats.gov.zm/>

represent two examples where the IMF has supported tentative monetary easing. In Tanzania the IMF notes that ‘monetary policy is envisaged to continue the current low interest rate environment and avoid a private sector credit crunch’ (IMF Country Report for Tanzania, No. 09/36, p. 14).

Mozambique and Tanzania are, however, the exceptions to the rule. While the IMF notes some moderation of inflationary pressures in the short run, it still warns of the need to maintain single-digit inflation in the medium and long run. Chart 5 demonstrates that all countries in our sample are expected to lower their inflation rates dramatically from 2008 to 2010, irrespective of their current rates and the types of inflationary pressures they face.

This record raises a number of important policy issues. First, the Fund’s understanding of the causes of inflation in LICs in the run-up to the global recession was fundamentally flawed. While the demand factors usually stressed by the IMF (such as rising fiscal deficits and excessive money supply growth) might have been important at other times and in other contexts, the high inflation rates experienced by LICs in 2007-08 were influenced decisively by exogenous supply factors such as rising food and fuel prices and structural bottlenecks. As a consequence, the contractionary monetary and fiscal policies that the IMF continued to recommend in many countries only served to intensify recessionary trends.

A second major point is that the IMF’s chief tool for cutting inflation rates is the policy interest rate. While the inverse relationship between the rate of interest and inflation might hold in high-income countries, this relationship is much weaker in LICs. In the latter grouping of countries, deep-seated structural bottlenecks and capacity constraints are a major source of inflation. If this is the case, the objective of easing inflation should be sought by addressing the underlying causes rather than relying on the ineffectual, and essentially counter-productive, tool of interest rate management.

Finally, the IMF claims that it is continuing to advocate higher interest rates not only to counter inflationary pressures but also to help foster financial deepening and encourage savings. This issue is particularly pertinent for many LICs, where the spread between deposit rates of interest and lending

#### **Box 4: Causes of inflation and IMF monetary policy advice**

The IMF has often continued to advocate monetary tightening. This has happened despite the reality that inflation in LICs is often caused by exogenous factors, such as rising food and fuel prices, and/or structural bottlenecks impeding supply responses. Yet, based on the Fund's traditional understanding, inflation is assumed to originate in the monetisation of fiscal deficits. This approach leads to the commonly adopted policy prescription to increase the policy interest rate in order to contain inflation. But such a monetary policy stance only serves to exacerbate the problem, making credit more expensive. This discourages private investment and worsens the terms on which government could raise debt domestically. Both impacts affect the way in which the productive capacity of an economy could be expanded, and how, as a result, structural bottlenecks in the economy could be relieved, thereby lowering inflationary pressures.

rates of interest is high. In Zambia, for example, commercial lending rates are over 10 percentage points higher than deposit rates. In these conditions, raising the policy interest rate is likely to boost payments on consumer and corporate debt, precisely at a time when many consumers and firms are struggling to remain solvent.

The distributional impact of this stance, once again, indicates the Fund's preference to protect the interests of the financial sector and the creditors, adversely affected by inflation and benefiting from higher rates, whereas it penalises the productive sector and borrowing families and firms, which face a higher risk of insolvency if credit supply is squeezed by higher policy interest rates. Without access to affordable credit, domestic demand remains suppressed and economic activity hindered by the disenfranchisement of local firms and borrowers to access the capital they need.

In summary, closer scrutiny of the IMF's engagement in our sample of 13 low-income countries has demonstrated that the IMF has granted minimal policy space to LICs during the current crisis. In the first instance, the IMF has allowed some variation in fiscal and monetary policy targets in our sample countries. The IMF's explanation for this variation is that these countries have diverse starting positions. We have illustrated the diversity in pre-crisis macroeconomic positions, but do not find support for

a close relationship between pre-crisis conditions and the Fund's advice on responses to the global crisis. Furthermore, the overall picture for our 13 sample countries is one of marginal and short-term fiscal and monetary accommodation, with a reversion to 'business as usual' in the medium to long term.

## Chapter 5

# TOWARDS AN ALTERNATIVE MACROECONOMIC FRAMEWORK

A BRIEF review of the February 2010 IMF Staff Position Note, ‘Rethinking Macroeconomic Policy’ by Blanchard, Dell’Ariccia and Mauro, can help us clarify the inadequacies of IMF advice on macroeconomic management and sketch the outline for an alternative macroeconomic framework and policies (see Blanchard et al. 2010). The IMF note takes a self-critical view of conventional assumptions about macroeconomic policies prior to the ‘Great Recession’ and seeks to identify ‘the contours of a new macroeconomic policy framework’ (p. 1).

In the end, however, it reverts to defending basically the same pre-crisis framework, albeit with some significant modifications. As it states on the last page, ‘in many ways, the general policy framework should remain the same’. But it notes that policymakers should monitor multiple targets, not just the inflation rate; and they should use multiple instruments, including fiscal policies and exchange-rate policies as well as monetary policies. This is a welcome break from the self-reinforcing complacency of the pre-crisis macroeconomic tradition.

This IMF note reaffirms the central assumption of the pre-crisis consensus that ‘the ultimate goals should be to achieve a *stable* output gap and *stable* inflation’ (italics added) (p. 16) though it recognises that output stability should be accorded more importance than was previously the case. However, in drawing out policy implications, the note confines itself, for the most part, to two limited topics: 1) how to combine traditional monetary policies with tools of financial regulation, and 2) how to design better automatic stabilisers as the preferred fiscal response to crisis.

Like other IMF documents, this note reaffirms the Fund's fundamental underlying assumption that macroeconomic policies are suited to dealing only with short-term stability issues. This conventional view assumes that if macroeconomic stability is ensured, then private-sector-led growth and development will follow.

In contrast, we take a longer-term, more development-oriented view of macroeconomic policies. This would imply, in part, that we are concerned with the 'composition' of macroeconomic policies, such as fiscal expenditures and credit allocation, and that we directly relate macroeconomic policies with structural policies, such as the ability of the state to mobilise domestic revenue and the financial system to mobilise domestic savings.

Ultimately, the ability of a government to implement more growth-inducing macroeconomic policies depends on its 'fiscal space', its ability to raise revenue and rely on debt instruments or external grants for financing. For LICs, reliance on external grants is pivotal for ensuring the 'fiscal space' that could be used to finance development expenditures. But in the medium to long term, it is critical to strengthen the revenue mobilisation capacities of the state. The issue of domestic resource mobilisation is at the centre of the differences between the IMF macroeconomic framework and our alternative framework but we are not able to concentrate on this issue in the current paper (see McKinley and Kyrili 2009 for an extended discussion).

### **More targets and instruments: an IMF rethink**

Along the way, the authors of the IMF Staff Position Note do open up the possibilities for more discussion and debate on some key issues. For example, the note acknowledges that prior to the crisis, central banks had been encouraged to adopt as their 'primary, if not exclusive, mandate' achieving 'stable and low inflation' (p. 3) but it questions the validity of this stance. In this regard, it also questions why central banks have been encouraged to adopt a very low inflation target, i.e., 2 percent.

The note offers a significant concession that 'the behaviour of inflation is much more complex than is assumed in our simple models and that we understand the relationship between activity and inflation quite poorly' (p. 7).

For example, it concedes that ‘core’ inflation could be stable and the output gap could nevertheless still be variable. However, it is important to underline, at this point, the inherent difficulty in understanding the relationship between inflation and the ‘output gap’ since the latter is an analytical ‘construct’ (namely, the gap between the assumed ‘full-employment’ output level and the current output level), which is not directly observable.

#### **Box 5: Limits of the IMF rethink**

Blanchard et al. (2010) seek to present an IMF ‘rethink’ of macroeconomic policy. However, the authors remain committed to the general policy framework that has inspired Fund programmes over many years prior to the crisis. The main ‘innovation’ is the admission that policymakers should monitor multiple targets, rather than be solely preoccupied with the inflation rate, and that multiple instruments should be deployed, including fiscal and exchange-rate policies, rather than just relying on monetary policy. Yet, the fundamental assumption that macroeconomic policies are suited only to dealing with issues of short-term stability persists. The assumption is that once macroeconomic stability is achieved, the private sector will undertake the necessary investments for growth. Such an assessment remains grossly inadequate for promoting development in low-income countries, in which substantial public investments in basic infrastructure will be necessary to accelerate and sustain growth. Furthermore, it remains to be seen whether the minor changes to policy design being advocated by Blanchard et al. will translate into policy practice. An inconsistency between research findings and policy practice has often characterised IMF operations.

While conceding the complexity of inflation and its relationship to output, Blanchard et al. remain preoccupied with the narrow concern of avoiding a Keynesian ‘liquidity trap’, a condition under which the policy interest rate could not be pushed below the obvious 0 percent nominal limit in responding to a severe recession. Hence, the note’s main monetary policy innovation is confined to raising the inflation target marginally to 4 percent in order to help avoid such a trap. It does not even envisage that inflation in the higher single digits, or even between 10 and 15 percent, could be compatible with output stability and growth.

In addition to questioning past practices of inflation targeting, the authors also question the adoption of only one instrument for monetary policy,

namely, the policy interest rate. This is a short-term rate over which the central bank can, it is assumed, exercise some influence through open-market operations. However, the financial crisis has demonstrated that measures such as ‘quantitative easing’ could be used to expand a central bank’s policy toolkit and ‘cyclical’ regulatory tools, such as capital ratios, could be used to complement standard monetary tools in dealing with asset inflation.

The note acknowledges what is now more generally accepted, namely, that financial regulation does indeed have macroeconomic repercussions. Hence, monetary policies are not adequate, by themselves, to counteract crises and financial policies should be given consideration in designing the macroeconomic framework.

Along similar lines, the authors also recognise that central banks must take account of the impact of exchange-rate policies on inflation. In other words, standard monetary policies need to be supplemented with additional instruments, such as ‘reserve accumulation and sterilised intervention’, which could be used to influence the exchange rate. This opens up the possibility for more active exchange-rate management – which many central banks, especially those in Asia, already employ, implicitly if not explicitly.

Blanchard et al. also consider according fiscal policies a greater role in macroeconomic management. The authors recall that active fiscal policies became the main Keynesian macroeconomic tool in the wake of the Great Depression and that fiscal and monetary policies were later given ‘roughly equal billing’ during the 1960s and 1970s. However, they go on to try to justify why, for various reasons, fiscal policies have taken a backseat to monetary policies in the last two decades.

The authors grant that Keynesian discretionary fiscal policies were still, all along, considered valid for combating ‘severe shocks’ – such as the current ‘Great Recession’. But they confine fiscal policies to the limited counter-cyclical function of providing stimulus during recessions, as well as, in symmetrical fashion, prudently restraining expenditures (building up budget surpluses) during booms.

One major reason why the authors tend to dismiss the value of *discretionary* fiscal measures is that they believe that their implementation is usually too belated to address a crisis. Thus, they concentrate their attention

on the much narrower topic of how to institute and design ‘automatic stabilisers’, such as progressive taxes or social insurance programmes.

### **A macroeconomic alternative**

The strategic framework of the Millennium Development Goals (MDGs), which was developed in the wake of the 2000 Millennium Summit, helped redirect the international debate on macroeconomic policies. By calling for substantial scaling up of external and domestic resources to meet the MDGs, the UN-led campaign helped highlight the need for more expansionary public-investment-led fiscal policies. The campaign highlighted the need for a quantum leap in resources in low-income and least developed countries in order to finance large-scale new investments in economic and social infrastructure, support the acceleration of economic growth and make rapid progress on basic human development over a 25-year period.

Increasingly, the stability-focused macroeconomic policies of the IMF began to collide with such a development-oriented agenda. One of the initial battles was waged on the threat of the so-called ‘Dutch disease’, which the IMF initially predicted would occur as a result of a sizeable infusion of external development assistance in low-income countries. ODA-financed increases in public expenditures were alleged to be detrimental because they would inevitably generate higher inflation and greater appreciation of the recipient country’s exchange rate.

The debate on ‘Dutch disease’ effects eventually converged towards the reasonable conclusion that some degree of higher inflation and greater appreciation would, indeed, occur as a natural outcome of the scaling up of ODA because they would be inevitable accompaniments of the necessary transfer of resources from the tradable-goods sector (exports) to the non-tradable-goods sector (including public services, where most of government expenditures would be concentrated). Moreover, any excessive bouts of inflation and appreciation could be adequately addressed by coordinating fiscal, monetary and exchange-rate policies. (See, for example, Weeks 2008.)

However, the IMF’s single-minded focus on monetary policies and

the threat of inflation (higher than the low single-digit range) constituted a roadblock to such a coordination of macroeconomic policies. Firstly, the IMF did not provide any real *discretionary* latitude for fiscal policies – much less fiscal policies focused on the priority of public investment in crucial basic services and infrastructure. The governing target for fiscal policies has been low fiscal deficits, so fiscal policies have rarely been freed from the shackles of short-sighted budget-tightening and allowed to finance development expenditures.

Secondly, the IMF did not favour any real management of the exchange rate, even for combating inflationary tendencies. Instead, it favoured exchange-rate flexibility, assuming that ‘inflation-targeting’ monetary policy would be an adequate instrument to contain inflationary pressures. This stance failed to recognise the high degree of volatility that such exchange-rate flexibility imparted to the economies of many low-income countries, particularly small countries with relatively open economies.

The experience of the ‘Great Recession’ of 2007-09 has altered the terms of the debate on macroeconomic policies. Confronted with the collapse of private expenditures, policymakers in industrialised countries have had no qualms about resorting to larger Keynesian-inspired counter-cyclical stimulus packages. This stance has implied the implementation of both more expansionary fiscal policies and more liquidity-focused monetary policies in these countries.

Hence, the current intellectual environment is potentially more conducive to arguing the case for the longer-term use of expansionary policies. But we have to move the debate beyond just ‘Crisis Keynesianism’ – which is confined to the endorsement of counter-cyclical policies – in order to introduce an additional ‘structuralist’ dimension that emphasises the developmental role of macroeconomic policies.

This shift in thinking is particularly important for low-income ‘underdeveloped’ economies. They will continue to need an MDG-related development framework, which justifies continued external financing of fiscal deficits. Prior to the global crisis, LICs were able to run sizeable fiscal deficits precisely because a significant proportion of their deficits was covered by ODA. This is, indeed, the purpose of ODA financing – namely, to enhance the

ability of governments in low-income countries to expand public expenditures for development-related purposes. Such external financing has become even more critical during the recovery from the current ‘Great Recession’, when counter-cyclical fiscal policies have become necessary to contain the negative impact of the global downturn.

### **The role of deficit financing**

It is important to stress that running deficits can be justified, in general, on two major counts. Government expenditures can be used to compensate for falls in private spending during economic downturns. This is the standard Keynesian rationale for boosting aggregate demand in order to support economic recovery.

In contrast, insisting on the containment of fiscal deficits during recessionary periods will make fiscal policy ‘pro-cyclical’. In other words, it would require government spending to fall as private incomes drop because government revenues would be adversely affected. The debate in advanced economies, such as in the US and the UK, is beginning to centre on this issue as fiscal conservatives lobby for an early exit from counter-cyclical policies.

More generally, running deficits is fully justified, even in normal times, if these are used to support public investment (Weeks and McKinley 2007). For LICs, this could be called the ‘development rationale’. Indeed, it does not make any real sense to use current revenues to finance public investment since the additional future revenues expected from the investment should pay off the debt that the government initially incurred.

For the purposes of long-term growth, the ‘development rationale’ is paramount. It is through this function that public investment can stimulate private investment and boost economy-wide labour productivity. This is based on building up essential economic and social infrastructure, on which private investment inevitably relies. Examples are roads, electrical grids, dams, irrigation works, and an educated, skilled and healthy workforce.

### Box 6: The role of deficit financing

Running deficits can be justified on two major counts. Government expenditures can be used to counteract falls in private demand in the economy. In addition, the government deficit can provide the means for supporting public investment. Indeed, in the context of the latter, it would be unduly restrictive to use current revenues to finance public investment, since the future revenues from the investment should pay off the debt that the government initially incurred. It is through this function of deficit-financed public investment that economy-wide labour productivity can be boosted and private investment stimulated.

Private investment necessitates the provision of essential economic and social infrastructure, including roads, electrical grids, dams, and an educated, skilled and healthy workforce. Public investment is the most efficacious means to assure their provision. Under conditions of less than full employment, which tend to prevail in LICs, public investment crowds in, rather than crowds out, private investment. Further, the expansion of productive capacity enabled by public investment improves the supply response in the economy and, as such, counteracts the inflationary pressures arising from the expansion of aggregate demand. Finally, monetary policy should play a secondary macroeconomic role, supporting the policy of deficit-financed public investment. It should accommodate expansionary fiscal policy by assuring that money supply grows in tandem with the growth in income (induced through deficit financing).

One of the standard critiques of MDG-oriented public investment – with which the IMF has sympathised – has been that it would not have a net beneficial impact on economic activity because it would ‘crowd out’ private investment. This is highly unlikely, however, in the context of low-income countries because there is a widespread under-utilisation of resources. As a consequence, there is usually ample ‘economic space’ for increasing public investment (Weeks and Patel 2007).

Under conditions of less than full employment – which is the ‘normal’ state of low-income countries – it is much more likely that public investment would ‘crowd in’ (stimulate) more private investment, particularly if it were concentrated on building up basic infrastructure. A proactive public investment programme should be able, in fact, to help stimulate private investment in the sectors of the economy that national policymakers consider of strategic importance.

Another standard critique of an MDG-related expansion of public investment is that it would tend to be inflationary. This outcome is also not very likely in low-income countries since public investment would expand the aggregate supply of goods and services along with stimulating more aggregate demand for them. The expansion of productive capacities that public investment would generate should help keep inflation at moderate levels – within a 15 percent range, if not within single digits.

There is, in fact, very little plausible evidence to suggest that there is a strong correlation between deficits in low-income countries, such as for financing public investment, and inflation. One of the reasons for the lack of correlation is that inflation in such countries is usually more structural in nature (such as being due to low domestic productivity in the agricultural sector) or externally determined (such as through importing high-priced food or fuels). In fact, utilising deficits to finance public investment in essential public goods should counteract domestic medium-term inflationary pressures.

### **The role of monetary policies**

As we highlighted above in our discussion of the recent Staff Position Note, ‘Rethinking Macroeconomic Policy’, IMF macroeconomic recommendations invariably accord the leading role to monetary policies, over both fiscal policies and exchange-rate policies. Such a stance is surprising since monetary policies tend to be ineffective in the underdeveloped context of many low-income countries, where the link between inflation and interest rates is weak and where structural constraints and bottlenecks dominate.

While some have argued that inflation hurts the poor (Easterly and Fischer 2000),<sup>14</sup> this can be questioned on a number of grounds. Rising inflation benefits debtors over savers and in this way penalises wealthier over poorer individuals. Furthermore, in most low-income countries where excess capacity exists, the inverse relationship between inflation and unemployment is stronger. Therefore, a small increase in inflation in these countries may lower unemployment significantly and thereby help lift more people out of poverty. In general, policies that try to keep inflation at very low levels do

so by raising interest rates and squeezing fiscal deficits. These policies will hit the poorest the hardest, as they will lead to big drops in income, jobs and essential public services (McKinley 2005).

Nevertheless, monetary policy is regarded as being ideally suited to achieving the main objective of macroeconomic policymaking, namely, the containment of inflation at low levels. The prevailing target for the inflation rate has been below 5 percent. The IMF Staff Position Note suggests that the only real debate is whether the target should be 2 percent (perhaps too low) or 4 percent. Although the IMF had acknowledged in recent years – at least in Africa – that inflation in the range of 5-10 percent in LICs would not likely have an adverse impact on growth, this apparently has never become corporate policy.

Within the IMF's conventional macroeconomic framework, inflation is assumed to originate in the monetisation of fiscal deficits (the buying of government debt instruments by central banks). It is not assumed to derive from structural roots, such as supply constraints and infrastructure weaknesses that the market itself cannot resolve. If there is indeed a structural basis to inflation, then IMF-endorsed monetary policy would tend to have an inherent bias towards maintaining real rates of interest that are higher than warranted to facilitate access to credit for investment by firms and families – as well as squeezing real wages, especially for public-sector workers.

Such a bias becomes more plausible when one examines the relationship between inflation and growth. There is very little empirical evidence to sustain the belief that an inflation rate below 15 percent has an adverse impact on economic growth (Pollin and Zhu 2006). There is still some dispute, based on mixed evidence, on whether growth would be adversely affected when the inflation rate is above 15 percent.

But focusing on such threshold levels could be misleading. For practical policymaking purposes, what is often more important is the source of inflation. Does inflation originate, for example, from the monetisation of fiscal deficits or from supply shocks? Or is it associated with a period of rapid growth, in which increased investment is driving up the prices of some inputs?

Understanding the sources of inflation would be important in order to select the most appropriate policy responses. A recent study of 28 countries

in sub-Saharan Africa found, for example, that inflation arose mostly from supply shocks, the inertial momentum of initial increases in inflation and sharp exchange-rate depreciations (Heintz and Pollin 2008).

The sharp increases in food and oil prices in 2008 were a recent example of an adverse external supply shock, over which national policymakers had little control. Responding effectively to such shocks is likely to require policies that are not focused on interest rates, or on inflation targeting. In fact, such shocks frequently cause prices to breach the low inflation targets set by IMF agreements. So, attempting inflexibly to maintain such low inflation by raising the policy rate of interest is most likely to worsen instability.

Not only would such a response tend to slow economic growth – already dampened by the supply shock – but it could also exacerbate inflation in the short term by making credit more expensive. Yet, a policy bias towards raising the policy interest rate still appears to be an uncontested option for the IMF – unless an economy has already been plunged into a severe recession (Pollin et al. 2008).

To make matters worse, this bias in monetary policy is often accompanied by efforts by ministries of finance to contain fiscal deficits to low levels. Both of these effects could dampen aggregate demand during recessionary conditions, and thereby, paradoxically, end up enlarging fiscal deficits.

If conventional monetary policies tend to have such effects, what then would be a preferable stance? The optimal approach should be to accommodate more expansionary, ‘investment-focused’ fiscal policies. In general, monetary policies are too ineffective in the context of low-income countries to be able to play the leading role in macroeconomic management.

The primary responsibility of monetary policy is to ensure that increases in liquidity, i.e., growth of the money supply, are adequate to meet the growing demand for money as a result of the growth-induced rise in incomes. This would imply continuously encouraging moderately low real rates of interest, which would help contain the borrowing costs for both the private sector and the government.

While the central banks of many LICs might nominally possess the ability to use standard monetary instruments (such as open-market operations, in which the central bank buys and sells government securities or other

financial instruments in order to maintain a target inflation rate), they are ineffective in doing so because of the underdevelopment of the domestic financial system, which prevents the supposed relationship between the money supply and the inflation rate from working as it should.

Central banks try to influence the inflation rate by buying and selling bonds and acting as a ‘price setter’ through their policy interest rate. But for such activity to be effective, a viable domestic market for public bonds – i.e., made up of a substantial financial and corporate sector – must exist. However, the financial sectors of most low-income countries tend to be dominated by a few banks, usually foreign-owned, and large non-financial corporations are typically restricted to the extractive sectors.

In some countries there might be a significant number of large non-extractive enterprises, as well as an elite stratum of high-income households, seeking financial forms in which to hold their wealth. But foreign bonds, especially from the advanced economies (such as the US and the EU bloc), offer a more secure form of wealth, and can be easily exchanged in world markets, whereas national bonds cannot be.

Central banks could attempt to counteract this initial disadvantage by setting the interest rate on government bonds high enough to induce large financial and non-financial corporations and rich households to purchase them. However, such a high interest rate would undermine the basis for stimulating private investment and economic growth by making the cost of credit too high.

IMF recommendations to use policy interest rates to drive down inflation to relatively low levels (namely, 2-4 percent) only tend to exacerbate the congenitally counter-productive effects of such monetary policies in low-income countries.

## **Management of the exchange rate**

If national policymakers in low-income countries implement expansionary fiscal policies and accommodating monetary policies, then managing the exchange rate needs to be considered as a complement to such a policy stance. Such management would be needed to reduce the

likelihood of a rapid appreciation of the exchange rate in response to any increase in inflationary pressures. In this policy framework, policymakers might intervene by keeping a stable and competitive exchange rate which is consistent with long-run growth and development objectives (Heintz and Ndikumana 2010).

In contrast, the IMF has favoured, in general, a non-interventionist *laissez-faire* exchange-rate regime, in which the rate is fully flexible, i.e., fully determined by market forces. According to the IMF, such a general policy recommendation stems from the previous historical tendency of governments to supposedly maintain over-valued exchange rates.

However, such flexibility tends to result in increased volatility of the nominal exchange rate because of the inability of policymakers to respond effectively to frequent terms-of-trade or capital-outflow shocks. Containing the effect of such shocks is a compelling reason to opt for some form of exchange-rate management.

Volatility of the exchange rate is particularly problematic for the macroeconomic stability of small open economies heavily dependent on external trade. Hence, it makes sense for such countries to manage the exchange rate instead of relying on domestic monetary policies to create an anchor for expectations, such as maintaining an inflation target.

Another major reason for managing the exchange rate is to seek to maintain, over the medium term, a rate that can foster broad-based export competitiveness and lead to greater structural diversification of the domestic economy. This is a strategic priority for many low-income countries because of their low export diversification. Achieving a stable and competitive exchange rate should take precedence over rigid monetary policy targets in such countries because much of their growth is dependent on external trade.

Management of the exchange rate could take various forms. Countries could implement a 'managed float', in which the exchange rate is allowed to oscillate in accordance with market forces but the central bank intervenes through the buying and selling of reserves in order to contain the oscillations within a predetermined band. Alternatively, a country could utilise a 'loose peg', which implies that the monetary authorities fix their domestic currency

to the value of another currency (such as the US dollar) or a basket of currencies but periodically adjust the value of the peg in order to maintain a competitive rate.

Managing the exchange rate is particularly important for developing countries that experience a boom in resource exports, as some began to do during the first half of 2008. A large influx of foreign exchange from such resource exports could lead to appreciation of the exchange rate. In addition, speculative capital could flood into the economy in the expectation that further appreciation is likely. If the magnitude of such portfolio investment is large enough, it would ensure that the exchange rate does indeed appreciate.

**Box 7: Uzbekistan's responses to the crisis – a counter-balance to IMF prescriptions**

Beginning early in its transition to a more market-based economic system, Uzbekistan became well known for its heterodox economic policies. But since it has insisted on charting its own development path, it has incurred a continuous stream of criticisms from international financial institutions and mainstream economists, and from the IMF in particular. The implementation of heterodox policies has continued, with considerable success, in the wake of the current global crisis. A number of points are worth noting about Uzbekistan in this regard:

- Uzbekistan confronted the global food and fuel crisis of 2008 from a fairly strong position.
- The structure of Uzbekistan's exports and imports compared favourably to that of many other developing and emerging economies.
- Its economy has not been afflicted by financial contagion since its financial liberalisation has been limited.
- Policymakers have mitigated the impacts of sharp shocks to Uzbekistan's exchange rate through a continuous process of 'crawling peg devaluations'.
- The Uzbek government's new Anti-Crisis Programme initiated a large counter-cyclical fiscal stimulus, equivalent to about 5 percent of GDP.

- Uzbekistan has had the 'fiscal space' to finance an ambitious investment programme, which has helped counteract any current slowdown and will likely support faster future economic growth.
- Unlike many other low-income economies, Uzbekistan has been able to mobilise ample domestic revenue, which remains over 30 percent of GDP.

In general, Uzbekistan's heterodox policies have served it fairly well. It was able to successfully moderate the hardships of its early transition, resume credible rates of economic growth by the late 1990s, and substantially restructure its economy to be more self-sufficient in such critical items as energy and food.

As a result, its restructuring has enabled it to avoid some of the worst effects of the current global crisis. Aspects of Uzbekistan's development model could certainly be criticised (see McKinley and Weeks 2009). Employment growth has consistently lagged behind economic growth and poverty reduction has been slow. Yet by any standard barometers of economic performance – as well as by comparison with other low-income countries – Uzbekistan has been relatively successful over two decades of transition and development, though its achievements appear to remain a frustrating puzzle to many, including the IMF.

For further elaboration of Uzbekistan's policies and development process, please consult: <http://www.soas.ac.uk/cdpr/publications/dv/file56073.pdf>

## **Regulating the capital account**

In October 2009, the Brazilian government introduced a 2 percent financial transaction tax on foreign investments in Brazilian stocks and fixed-income securities in order to arrest the continuing appreciation of the real. This action highlighted the continuing debate on the advisability of management of the capital account – in addition to management of the exchange rate.

As growth languishes in advanced economies, emerging-market economies continue to face the problem of a rise in speculative inflows of capital. Such a problem also tends to be shared by low-income countries that export valued commodities, such as copper or oil. However, most LICs mainly confront the continuous outflow of domestic private capital from

their economies, i.e., ‘capital flight’. This problem is further aggravated by the continued outflow of FDI profits related to tax evasion and avoidance, amounting to an annual loss in government revenue in the range of US\$160 billion every year.

LICs have to find the means to discourage such capital outflows. Whereas tax evasion and avoidance need to be addressed by enhancing national tax systems, and global regulation on tax-related matters, ‘capital flight’ linked to speculative activities could be addressed by some limited management of these countries’ capital accounts, which should be regarded as complementary to the management of their exchange rates.

It is difficult to implement independent monetary policy (and even fiscal policy) without some management of the capital account. Such measures would be especially appropriate when a government is pursuing a more growth-oriented set of economic policies, which would imply more expansionary fiscal and monetary policies.

An insightful 2008 paper (Ndikumana and Boyce 2008) provides estimates of the scale of the problem of ‘capital flight’ for developing countries. It sought to gauge the extent of such outflows in 40 African countries during the period 1970-2004. The findings: the real stock of flight capital, calculated in 2004 dollars and including imputed interest, totalled US\$607 billion in 2004. This total exceeded these countries’ combined external debt by US\$398 billion. The implication: these African countries had been net creditors to the rest of the world.

During the unfolding of the global financial crisis in late 2008 and early 2009, many LICs were also subject to the general phenomenon of the ‘flight to safety’, in which private capital was fleeing the financial markets of developing countries in favour of more risk-free havens in rich countries. Ironically, speculative capital began flowing back into US financial assets, particularly government securities. As a result, many developing-country currencies began to depreciate.

Although the amount of private capital flows to LICs is minimal compared to the total flows to developing countries, it represents a substantial share of LICs’ economies (as much as one-third of the GDP in sub-Saharan Africa).<sup>15</sup> Thus volatility of these types of flows strongly impacts the financial

stability of the world's poorest countries.

Hence, the global phenomenon of the volatility of capital flows, particularly portfolio investment, signals the need to consider some form of management of the capital account. In the wake of the experience with unregulated international flows of private capital during the Asian financial crisis in the late 1990s, the Fund and other multilateral and regional institutions have taken a more open attitude towards capital management techniques. Their preference has been, however, for market-based, temporary techniques.

A recent IMF Staff Position Note (Ostry et al. 2010) concludes that under certain conditions, 'use of capital controls ... is justified as part of the policy toolkit to manage inflows. Such controls, moreover, can retain potency even if investors devise strategies to bypass them'. The reason is that such strategies could be more costly than the expected return from the transaction. This logic was, no doubt, the motivation for the modest Brazilian financial transaction tax.

Developing countries can choose among various options when considering capital controls, based on the historical experience of numerous countries in implementing such measures. Grabel (2004) provides a promising option, which she calls a system of 'trip wires' and 'speed bumps'. When a 'trip wire' is hit, this signals that a country is approaching high levels of risk on a particular dimension of private capital flows – such as the danger of a rapid outflow of portfolio investment.

An example of a 'trip wire' indicator related to portfolio investment would be the total accumulated foreign portfolio investment in a country as a ratio to its gross equity market capitalisation. When such a ratio grows too high, the government could begin implementing a graduated series of 'speed bump' measures, well before the outbreak of any crisis, which could slow the entrance of new portfolio investment, until the ratio begins to decline from critical levels. The main capital management techniques that low-income countries should consider are those that can slow down the outflow of speculative portfolio investment. An example would be 'residence requirements' of one year (or probably even less) before such investment flows can be taken back out of the country.

**Box 8: Post-crisis recovery in sub-Saharan Africa: Despite or because of the IMF?**

Since the beginning of 2010 the IMF has begun to engage more openly with civil society organisations, setting up a number of meetings to champion the IMF under a ‘theme of change’. A central element of these encounters between CSOs and the IMF has been the highlighting of how the IMF has responded to the current crisis faster, with greater resources and with greater flexibility than it has in the past. Furthermore, focusing particularly on sub-Saharan Africa (SSA), the Fund notes that low-income countries there are faring much better than in previous crises. The reason for the speed and symmetry (with the rest of the world) in the recovery of SSA countries, according to the IMF, is the improved macroeconomic position of LICs at the advent of the crisis. This improved starting position is then related to the adoption of IMF policy prescriptions by the governments of these countries. In the IMF’s view, countries did not only have *better* policies in place but also benefited from a greater ability to implement them.

This self-assessment by the IMF needs close examination:

**Firstly**, it is still too early to determine whether or not countries are faring relatively better than in previous crises and the IMF’s rosy assessment concerning the prospects of SSA countries is premature.

**Secondly**, the issue concerning the improved starting position is a complex one since many countries have benefited from higher commodity prices and larger capital inflows during the mid-2000s than before. Debt relief through the HIPC and MDRI initiatives has also played its part in lowering debt servicing and hence the fiscal burdens of SSA countries.

**Thirdly**, the current global crisis has differed considerably from previous world recessions and crises since it originated in the North and was largely financial in origin. Most SSA low-income countries, by virtue of their relatively limited financial-market development and integration with global markets, have therefore been spared the potentially direct impacts of this crisis.

**Fourthly**, emerging-market donors and investors in SSA, most notably China, have played a large part in cushioning the impacts of the crisis through their continuous engagement with these countries.

## Chapter 6

# CONCLUSION

THIS paper has sought to assess the IMF's macroeconomic framework and its renewed and strengthened role in low-income countries following the food, fuel and financial crises of 2007-09.

Chapter 2 provided information on the effects of the current crisis on LICs as a context for our subsequent assessment. In Chapter 3 we initiated our assessment through an evaluation of the IMF's own recent publications on its general macroeconomic framework. In Chapter 4 we examined in detail the nature of the IMF's engagement during the recent crises in a representative sample of 13 low-income countries.

These two chapters have allowed us to construct a comprehensive assessment, at both the global and national levels, of the IMF's current role and the nature of its policy prescriptions. In Chapter 5 we contrasted the IMF approach to the outlines of an alternative macroeconomic framework which we believe would be more conducive to growth, development and poverty reduction.

This paper began by posing three central questions, to which we can now return as a summing up of our assessment. The first question was whether there had been significant change in IMF programmes in low-income countries, as the IMF itself has claimed. Our assessment is that there has been very little fundamental change. Instead, the IMF has remained committed, despite some marginal changes, to its pre-crisis policy priorities.

Despite the Fund's own claims to the contrary, the prioritisation of price stability over other macroeconomic goals is evident through close

scrutiny of the Fund's general publications as well as through its engagement with our representative sample of countries. While the Fund has allowed some countries some additional room to manoeuvre, on both the fiscal and monetary fronts, the underlying macroeconomic framework that it promotes has remained the same. Fiscal policy has remained essentially subservient to inflation-targeting monetary policy and has been reduced to functioning as a set of automatic stabilisers during both booms and busts.

The second question that this paper posed was whether the Fund has provided sufficient policy space for LICs to address the crisis. We have based our assessment primarily on close examination of the IMF's engagement in our sample of 13 low-income countries and, in doing so, have focused on both fiscal and monetary policies.

We have concluded that on the fiscal front recent IMF programmes have indeed allowed for marginally higher deficits during the brunt of the crises, although even on this score there have been significant variations in the allowed latitude. However, not only has the relaxation of deficit targets been marginal in size but it has also proved to be shortlived, as the Fund has already begun advocating tighter fiscal policies starting in 2010.

This dynamic has been the same for monetary policy space. Not only have inflation targets for most low-income countries been set relatively low, but the IMF's diagnosis of the sources of inflation has also been inaccurate. We have argued that much of the inflation in LICs has been structural in nature or externally determined, not driven by excessive domestic aggregate demand triggered by large fiscal deficits and loose monetary policies. Hence, we believe that the Fund's continued reliance on the policy interest rate as its primary monetary policy tool will fail to address the fundamental causes of inflation, if not make macroeconomic conditions worse.

The third major question that this paper posed was how IMF programmes have related the objective of short-term stabilisation to the longer-term objectives of growth, development and poverty reduction. Our assessment is that Fund policy recommendations, despite declarations of increased flexibility, have remained conditioned by a short-term bias, focused primarily on maintaining price stability.

The current set of global crises has jolted the Fund into recognising

the importance of maintaining output stability – in addition to price stability – and accepting the need for counter-cyclical fiscal policies. But the policy implications flowing from such recognition remain fairly limited. The Fund has failed to move beyond what could be termed ‘Crisis Keynesianism’. In fact, it is already proposing to rein in fiscal policies beginning in 2010 in order to ensure that inflation is not increased and fiscal surpluses will be prudently accumulated during any ensuing boom.

In other words, the IMF is already laying the groundwork for reverting to its traditionally restrictive macroeconomic framework. But such a policy stance remains inconsistent with the compelling need of low-income countries to recover quickly from the impact of the global crises and accelerate, as soon as feasible, their growth, development and reduction of poverty. In fact, such a reversion to macroeconomic form could jeopardise a sustained economic recovery.

# RECOMMENDATIONS BY EURODAD AND THIRD WORLD NETWORK

AS the IMF starts reviewing its mandate as a result of the central role it was accorded by the G20 in the aftermath of the global crisis, it is crucial to reassess the advisability of the institution's playing a strengthened role in low-income countries.

This report highlights the profound limitations of the Fund in providing development- and recovery-oriented macroeconomic policy advice to the world's poorest countries, as well as its resistance to change even in the aftermath of the crisis. In light of the findings, Eurodad and Third World Network put forward the following set of recommendations outlining urgently needed reforms and sketching out the longer-term role (or lack thereof) of the Fund in low-income countries.

## **Urgently needed reforms at the IMF:**

### ***To the IMF:***

- The Fund should discontinue the practice of attaching economic policy conditions to its lending to low-income countries.
- The Fund should expand the use of the newly created Rapid Credit Facility for low-income countries, providing quick access to financial assistance in cases of balance-of-payments needs without outright programme-based conditionality.

- The Fund should systematically assess, with input from other international agencies, how their macroeconomic policy advice impacts low-income countries and whether it constrains their ability to undertake economic and social policies that spur equitable development and poverty eradication.

***To the IMF's developed-country shareholders:***

- IMF financial support for addressing balance-of-payments disequilibria in lending must not be linked to the provision of macroeconomic advice and technical assistance from the IMF. Instead, low-income countries should be allowed to decide on the most appropriate institutional source for such advice among a broader range of options, which could include UN agencies, and regional or national institutions including think-tanks and academia.
- Delink bilateral aid allocation and disbursement from existence and status of IMF programmes.
- In order to ensure broader views on what sound macroeconomic policy means for low-income countries, the voice and vote of LICs at the Fund needs to be substantially strengthened.

***To low-income countries:***

- Make use of the renewed debate on macroeconomic policy opened up by the global crisis to explore a broader set of macroeconomic policy options that accelerate growth and poverty eradication.

**Reforming the IMF mandate in low-income countries:**

***To the IMF shareholders:***

- The role of the Fund as provider of macroeconomic advice to low-income countries should be profoundly reassessed. Given the inelasticity to change of the institution, efforts should be made to

engage other agencies which would allow diversifying policy advice. These roles should be progressively replaced by other institutions and agencies, including regional and national ones, which are better placed to provide this type of advice.

- The IMF should restrict its financial support to low-income countries to addressing balance-of-payments shocks and providing financial support for short-term needs. This should include making Special Drawing Right allocations for LICs that are facing financing gaps on the basis of need, rather than on the basis of quotas. The IMF must discontinue engaging in recurrent financial support to LICs which requires a longer-term development perspective of economic policy design absent from the Fund's mandate and expertise.

### **Exploring alternative macroeconomic policy designs for low-income countries:**

The global crisis has put in the spotlight the relevance of macroeconomic policies for stability and growth. However, it cannot be overemphasised how macroeconomic policy frameworks set the terms in which development strategies and social policies can or cannot be undertaken.

Alternative macroeconomic policies that accommodate growth- and development-oriented strategies should urgently be explored. Rather than providing another blueprint for how macroeconomic policy design should be undertaken, the following recommendations outline the scope for alternatives, based on the assumption that any policy options need to be country-specific:

- Fiscal policy can play a crucial role driving the development process through public investment.
- Deficit financing can be fully justified, even in normal times, if used to support sound public investment, which can stimulate private investment and boost economy-wide labour productivity.

- Monetary policy could play only a secondary role, accommodating more expansionary, investment-focused fiscal policies. This would entail encouraging moderately low real rates of interest (which should thus not be raised to contain inflation below 5 percent, exacerbating recessionary trends).
- Exchange-rate management can play a role to reduce volatility of the nominal exchange rate, and to maintain a rate that can foster broad-based export competitiveness and lead to greater structural diversification of the domestic economy.
- In addition, regulating the capital account could be a tool for developing countries to curb capital flight and reduce speculative inflow of capital.

## Endnotes

- 1 See 'G20 reaffirms IMF's central role in combating crisis', IMF Survey Online, April 2009, available at: <https://www.imf.org/external/pubs/ft/survey/so/2009/NEW040309A.htm>.
- 2 The resources for the Fund's concessional assistance to low-income countries, which include low-interest loans under the Poverty Reduction and Growth Facility (PRGF) and Exogenous Shocks Facility (ESF) and debt relief under the Heavily Indebted Poor Countries (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI), are funded by member contributions and by the IMF itself, with the IMF's own resources linked to its gold sales. As part of its crisis response, the IMF was hoping, subject to consent from its lenders, to provide exceptional interest relief on its concessional loans to all LICs, with zero interest payments through end-2011 (see <http://www.imf.org/external/np/exr/facts/finfac.htm>).
- 3 See 'IMF financial package for low-income countries: much ado about nothing?', available at: [http://www.twinside.org.sg/announcement/IMF.Financial.Package.for.Low-Income.Countries\\_Joint.civil.society.briefing-7%20Aug.09.pdf](http://www.twinside.org.sg/announcement/IMF.Financial.Package.for.Low-Income.Countries_Joint.civil.society.briefing-7%20Aug.09.pdf); Molina-Gallart (2009); Rowden (2009a and b); Muchhala (2009); and Weisbrot et al. (2009).
- 4 In January 2010 the Extended Credit Facility (ECF) succeeded the PRGF as the Fund's main tool for providing medium-term support to LICs. The ECF was created under the newly established Poverty Reduction and Growth Trust (PRGT) (see <http://www.imf.org/external/np/exr/facts/ecf.htm>). As this study considers IMF programme engagement over 2007-09, the old programme titles are used throughout the text.
- 5 Green, Duncan; King, Richard; and Miller-Dawkins, May: 'The global economic crisis and developing countries: impact and response', Oxfam Research Reports, January 2010.
- 6 For a detailed account of the repercussions of food and fuel crises in least developed countries (LDCs), see UNCTAD (2008, pp. 77-83).
- 7 See Martins et al. (2009, pp. 28-44) for an overview of the various effects of the global financial crisis in African economies.
- 8 The majority of Tajikistan's remittances derive from workers employed in Russia's construction industry, which has been hit hard by the global recession.

- 9 Ghana is an exceptional case since it recently re-engaged with the Fund by entering into a PRGF arrangement in August 2009, following six years of non-engagement. It is therefore not included in the IMF's own sample of countries with continuous IMF engagement.
- 10 In Sierra Leone and Zambia the very large surpluses in 2006 can be linked to the receipt of debt relief through the Multilateral Debt Relief Initiative (MDRI).
- 11 Berg et al. (2009, p. 4) note that the size of automatic stabilisers is smaller in sub-Saharan African (SSA) countries because of generally lower revenue-to-GDP ratios and that tax systems and public expenditure structures are not very sensitive to the cycle. In particular, the average revenue-to-GDP ratio in non-oil-exporting SSA countries is 21 percent, compared to an average revenue-to-GDP ratio of over 40 percent in developed countries. In addition, a large fraction of revenue in sub-Saharan African countries is generated by indirect taxes, which tend to vary proportionately to the output gap (i.e., the elasticity with respect to the output gap being close to 1). For many sub-Saharan African countries, changes in commodity prices would have been the main driver of the fiscal outcome in 2009. For example, average revenue as a percentage of GDP for 2000-06 for our sample countries ranges between 12.4 percent (Rwanda) and 21.9 percent (Kyrgyz Republic) – excluding Mongolia (34.1 percent) (source: IMF Country Documents, various years).
- 12 In an IMF Staff Position Note on fiscal policy and the crisis in SSA, Berg et al. (2009, p. 6) clarify that the terms 'expansionary fiscal policy' and 'fiscal expansion' cover both cases in which automatic stabilisers are allowed to work and those in which, in addition, discretionary fiscal stimulus measures are implemented.
- 13 Rowden, Rick: 'Doing a decent job? IMF policies and decent work in times of crisis', SOLIDAR, Global Network and Eurodad, October 2009.
- 14 Easterly and Fischer (2000) in a survey of poor people in 38 countries find that they are more likely than the rich to mention inflation as a top national concern.
- 15 Bhinda, Nils and Martin, Matthew: 'Private capital flows to low income countries: dealing with boom and bust', Foreign Private Capital Capacity Building Programme, November 2009.

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## APPENDIX: OUTLINING THE SAMPLE COUNTRIES

THE sample of countries that provide the empirical basis for our findings in this report consists of 13 countries. These are: Benin, Ethiopia, Ghana, Kyrgyz Republic, Malawi, Mongolia, Mozambique, Rwanda, Senegal, Sierra Leone, Tajikistan, Tanzania and Zambia. These countries were selected to represent a broad array of countries that were engaging with the IMF on differing terms. The sample includes six countries (Benin, Kyrgyz Republic, Malawi, Rwanda, Sierra Leone and Zambia) that were part of the sample selected in IMF (2009a) and that have had ‘continuous programme engagement with the Fund under the PRGF during January 2007-June 2009’ (p. 13). The sample also includes countries that have not had continuous engagement with the IMF through the PRGF but instead have been engaged with the Fund through other lending facilities. Table A1 lists the countries and indicates the nature and the extent of their involvement with the IMF over recent years.

The sample countries vary not only on the basis of IMF lending facilities but also on the basis of different macroeconomic contexts. For example, some countries have flexible exchange-rate regimes, such as Ghana, Tanzania and Zambia, while others have pegged exchange-rate systems, such as Benin and Senegal. The latter two countries are members of the West African Economic and Monetary Union (CFA Franc Zone). The sample also covers countries with different levels of aid dependence. Malawi, Rwanda and Sierra Leone top the table of aid-dependent countries within our sample, while Benin, Ghana, Mongolia, Senegal and Tajikistan

**Table A1: Sample Countries and IMF Engagement**

<b>Country</b>	<b>Start Date</b>	<b>Type of Programme</b>	<b>IMF Borrowing (SDR million)</b>
Benin	Aug-05	PRGF	24.8
Ethiopia	Jan-09	Exogenous Shocks Facility	153.8
Ghana	Aug-09	PRGF	387.5
Kyrgyz Rep	Mar-05	PRGF	66.6
	Nov-08	Exogenous Shocks Facility	17.8
Malawi	Aug-05	PRGF	52.1
	Jan-09	Exogenous Shocks Facility	52.1
Mongolia	Apr-09	Stand-by Arrangement	153.3
Mozambique	Jul-07	Policy Support Instrument	113.6
	Jul-09	Exogenous Shocks Facility	11.4
Rwanda	Jul-06	PRGF	8
Senegal	Nov-07	Policy Support Instrument	121.4
	Jan-09	Exogenous Shocks Facility	24.3
Sierra Leone	May-06	PRGF	51.9
Tajikistan	Jun-08	Staff Monitored Programme	78.3
	Apr-09	PRGF	65
Tanzania	Apr-07	Policy Support Instrument	218.8
	Jun-09	Exogenous Shocks Facility	19.6
Zambia	May-08	PRGF	220.1

Source: *IMF Country Documents, various years.*

have had ODA-to-GNI (gross national income) ratios under 10 percent in recent years.

Countries in the sample also have different growth and poverty reduction trajectories. Some have experienced GDP per capita growth rates of 6-8 percent before the crises (e.g., Ethiopia, Malawi, Mongolia and Tajikistan). In contrast, the per capita GDP growth rates of Benin and Senegal have struggled to reach 2 percent over the pre-crises years. Similarly, efforts at reducing poverty have been mixed across our sample. Ghana, Kyrgyz Republic and Tajikistan are examples of countries on track to reaching MDG 1, having made significant progress in lowering national poverty rates. Benin and Malawi, on the other hand, have seen the numbers of people living below the poverty line increase over recent years and are far off-track in terms of reaching MDG 1.

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The International Monetary Fund (IMF), which has been criticised for the rigid economic policy conditionalities attached to its lending programmes, says it now provides borrower states greater flexibility to adopt expansionary policies. *Standing in the Way of Development?* assesses this claim in the context of the IMF's central role in dealing with the effects of the global financial crisis in low-income countries (LICs).

This paper evaluates the general macroeconomic policy scheme promoted by the Fund and closely examines the nature of its engagement during the crisis in a representative sample of 13 LICs. The authors find that, despite some relaxation of policy restraints, the IMF essentially remains wedded to its longstanding prioritisation of price stability and low fiscal deficits over other macroeconomic goals.

Such a policy stance, it is argued, could undermine not only LICs' prospects for a quick recovery from the crisis but also their longer-term development outlook. In light of this, this paper outlines the broad contours of an alternative macroeconomic policy framework geared towards supporting long-run equitable growth and poverty reduction.

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