IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-One Borrowing Countries

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Introduction

This paper arises out of discussions with the International Monetary Fund (IMF) over the Fund's recommended macroeconomic policies during the course of the current world recession. In a panel discussion held on June 19, 2009, there was disagreement between the IMF and CEPR over whether or to what extent the IMF has supported pro-cyclical policies in borrowing countries during the current world recession. CEPR agreed to take a comprehensive look at current IMF agreements, as a prelude to further discussions with the Fund on this issue.

This paper looks at IMF agreements with 41 countries. These include Stand-By Arrangements (SBA), Poverty Reduction and Growth Facilities (PRGF), and Exogenous Shocks Facilities (ESF).[1]

The paper finds that 31 of the 41 agreements contain pro-cyclical macroeconomic policies. These are either pro-cyclical fiscal or monetary policies – or in 15 cases, both – that, in the face of a significant slowdown in growth or in a recession, would be expected to exacerbate the downturn. In some cases, the Fund subsequently relaxed the original conditions; sometimes (as in Hungary, Latvia, Republic of Congo, and Haiti) this appeared to be the result of social unrest or other pressures on the borrowing government. These relaxations of fiscal and monetary policy are noted in the text below, but the original agreements are included in the tally because they still represent, in the authors' opinion, a policy mistake that may have caused unnecessary economic harm during the time when the policy was in effect.

In many cases the Fund's pro-cyclical policies were based on over-optimistic assumptions about economic growth. For example, of the 26 countries that have had at least one review, 11 IMF reports had to lower previous forecasts of real GDP growth by at least 3 percentage points, and three of those had to correct forecasts that were at least 7 percentage points overestimated. Most likely there will be more downward revisions to come.

The Fund might respond that it could not be expected to anticipate the depth of the world recession and its impact on developing countries through exports, capital inflows, remittances, access to trade credits and other channels. But the Fund should have been more careful in its projections and should have anticipated a severe downturn that would have serious effects on low-and-middle-income countries. The United States, which is about one-quarter of the world economy, officially went into recession in December of 2007. The cause of this recession was both foreseeable and foreseen; for example some economists began writing about the housing bubble in 2002,[2] and while no one could anticipate exactly when it would burst, the size of the bubble as it grew was continuously tracked; and well before it peaked in 2006, it was clear that this would have a huge impact on both the U.S. and world economy. Other economists such as Nouriel Roubini[3] focused more on the impact that the anticipated bubble collapse would have on the financial sector. All of this data and analysis was available to the Fund, which has one of the largest economic research

[1] For an explanation of these three lending facilities, see the following:
IMF. 2009. "IMF Lending." http://www.imf.org/external/np/exr/facts/howlend.htm
IMF. 2009. "The Poverty Reduction and Growth Facility (PRGF)." http://www.imf.org/external/np/exr/facts/prgf.htm
IMF. 2009. "The Exogenous Shocks Facility (ESF)." http://www.imf.org/external/np/exr/facts/esf.htm

[2] See for example Baker 2002.

[3] See for example Roubini 2006.

departments in the world. The Fund publishes the World Economic Outlook every six months, the purpose of which is to analyze current trends; the WEO missed this enormous bubble and its likely consequences.

By the time of the IMF projections that are included in this paper, the world recession was well underway. It should have been obvious, even before the deepening financial crisis that followed the collapse of Lehman Brothers, that this recession would lead to a sharp fall-off in capital flows to developing countries. There was a sharp decline of these flows after the bursting of the stock market bubble (in 2000-2002), which caused the U.S. recession of 2001[4]. It was very clear to those who had analyzed both of these bubbles that this recession would be far worse, and have a much bigger impact on developing countries not only through the financial sector, but also through trade and other avenues. According to the World Bank, net private capital inflows to developing countries dropped from a $1.2 trillion peak in 2007 to $707 billion by the end of 2008 and a projected $363 billion in 2009.[5]

It is also worth noting that the IMF has a history of over-optimistic projections in many countries.[6] So it is not so easy to separate forecasting errors from an underlying bias toward overly restrictive fiscal and monetary policies.

The same is true with regard to the Fund's treatment of inflation during 2008, when there was a huge run-up in commodity prices. In some countries this was part of the IMF's rationale for tight monetary policy, even in the face of negative external shocks that slowed growth. For countries whose government budgets were negatively impacted by oil price increases, this was also part of the rationale for pro-cyclical spending cuts. The Fund should have anticipated that most of this inflation was temporary, and treated it as such when formulating macroeconomic policy.

Over the past year or two the IMF has been a strong supporter of the use of government fiscal stimulus to counter-act the world recession, and it has long supported expansionary monetary policies, e.g. in the European Union, as well. It may then seem paradoxical that so many of the IMF's agreements concluded during this recession have been pro-cyclical. But there has long been a double standard for low-and-middle income countries, in that Fund policy does not allow or encourage the same types of expansionary macroeconomic policies as it recommends for the high-income countries.

The economic argument for this double standard is that developing countries face a much more binding foreign exchange constraint. That is, if they stimulate their economies during a downturn they run the risk of expanding current account deficits and therefore running low on foreign exchange. Countries with hard currencies (the United States, Eurozone countries, Japan) do not face the same constraint, and of course the U.S. has the added advantage that the U.S. dollar is the world's key currency. However, developing countries that have sufficient reserves are in very much the same position as the high-income countries. A prime example of this is China, with more than

[4] IMF 2002.
[5] World Bank 2009.
[6] See for example Baker and Rosnick 2003 and Rosnick 2009. The main exception has been countries where the IMF has had strong policy disagreements with the governments, where it has sometimes had huge forecasting errors in the other direction (see Rosnick and Weisbrot 2007)

two trillion in international reserves, which has implemented perhaps the world's most effective stimulus program during this recession.

The purpose of IMF lending during a world recession should be – as much as possible – to provide sufficient reserves so that borrowing countries can pursue the expansionary macroeconomic policies that high-income countries are capable of, in order to minimize the loss of employment and output, as well as more permanent or long-lasting damage that sometimes occurs in the most vulnerable countries. Of course some countries headed into this downturn with unsustainable fiscal or current account deficits; but even in these cases there should be a strong bias towards waiting until the world recession has passed before attempting to adjust these deficits. Other countries may have an unsustainable debt burden; in these cases there is an argument for more and speedier debt cancellation in the near future, rather than trying to improve the fiscal balance while the economy is crashing.

In some countries the rationale for tightening macroeconomic policies during the current downturn has been to restore confidence as a result of capital flight. In these cases, the IMF should be more open to capital controls, which it does not recommend in any of the agreements, and in some cases (e.g. Pakistan) it opposes these measures. In any case this is rarely a sufficient justification to prescribe pro-cyclical macroeconomic policy, especially if the Fund is capable of providing sufficient reserves to restore confidence. That is the purpose of the Fund's new Flexible Credit Line, which has provided a large credit line without conditions. It has worked very well, and is a major improvement in IMF policy; but unfortunately it has only been made available to three countries: Mexico, Colombia, and Poland. Now that the Fund's resources have been boosted by hundreds of billions of dollars to unprecedented levels, it should consider providing this kind of support to other countries. Most of the countries that would need this kind of a credit line have vastly smaller economies than Mexico, Colombia, or Poland; so there is plenty of room to expand it.

In the case of Latvia, for example, the pro-cyclical policies have been part of an effort to preserve a pegged exchange rate. This is similar to IMF-supported policy in Argentina during their steep recession of 1998-2002, where a fixed, overvalued exchange rate was supported with tens of billions of dollars of loans until it inevitably collapsed. In cases such as Argentina and Latvia, maintaining the peg means that adjustment must take place through shrinking the economy and real wage declines. Latvia's GDP is projected to shrink by 18 percent this year.[7]

Of course the IMF has to be concerned with the borrowing country's ability to repay the loans, but it is possible that the Fund's risk aversion in this regard is too extreme, and leads to unnecessary pro-cyclical policies. For example, in the case of Ukraine, the Fund recommended pro-cyclical policies despite the fact that Ukraine's public debt was just 10.6 percent of GDP.[8] But regardless of the cause, it is time for the Fund to re-examine the criteria, assumptions, and economic analysis that it uses to prescribe macroeconomic policies in developing countries.

This paper does not focus on other aspects of IMF policy in the current agreements that may also be in need of reform. As can be seen below, in many poor countries the agreements focus on reducing the public wage bill, privatizations, and liberalization. While in some cases these reforms

[7] IMF 2009.
[8] See Weisbrot 2009.

may be justified, there are undoubtedly others where they may run counter to the long-term development needs of the borrowing countries.

About the Criteria

In this paper we counted as pro-cyclical fiscal policy a programmed reduction in the fiscal deficit (or an increase in the fiscal surplus) during a recession or significant growth slowdown. For example, in Hungary, the IMF agreement in 2008 called for reducing the fiscal deficit from –3.4 percent of GDP in 2008 to –2.5 percent of GDP in 2009, while GDP growth fell from 0.5 percent in 2008 to a projected –6.7percent for 2009.

Similarly, we counted as counter-cyclical a programmed decrease in the fiscal surplus (or an increase in the fiscal deficit).

On monetary policy, an increase in policy interest rates during a recession or significant growth slowdown was counted as pro-cyclical, with an interest rate cut as counter-cyclical. For money supply targets, some agreements did not target money supply growth, and thus were not counted as pro-cyclical or counter-cyclical on the basis of this measure. Some explicitly indicated a tightening of monetary policy, e.g. "monetary policy will be tightened moderately, with reserve money growth below growth in nominal GDP."[9] These agreements were counted as tightening monetary policy. For other agreements that did not specify the direction of monetary policy, if money supply growth was significantly less than nominal GDP growth, then that was counted as a tightening.[10]

We recognize that it is not always easy to determine whether an IMF program is pro-cyclical, counter-cyclical or neutral based on these key macroeconomic policies. In cases where it was not clear, a blank was left in Table 1. Still there can be differences over how to measure this. We look forward to further discussions with the IMF to reach more clarity on these policies.

This year the IMF has taken action more akin to a Central Bank's function as lender of last resort, by making available for borrowing some $283 billion of Special Drawing Rights (SDR's IMF reserve assets that can be exchanged for hard currency) to member countries without conditions. While most of this will be available to high-income countries who will not borrow it, there will still be a significant amount going to low-and-middle-income countries, including about $20 billion to the Low Income Countries. This money can be borrowed without conditions. While many low-income countries cannot afford to take on new debt, this unconditional lending and injecting liquidity into the world economy by the IMF, in a time of world recession represents an unprecedented step forward. The next step should be to eliminate harmful conditions attached to other IMF lending facilities.

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[9] See p.20, "Sierra Leone: 2008 Article IV Consultation, Third Review Under the Three–Year Arrangement Under the Poverty Reduction and Growth Facility, Financing Assurances Review, and Requests for Waivers of Nonobservance of Performance Criteria, Augmentation of Access, and Modification of Performance Criterion—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Sierra Leone." January. http://www.imf.org/external/pubs/ft/scr/2009/cr0902.pdf.

[10] We used trend nominal GDP growth, since some countries had negative current nominal GDP growth because of recession.

TABLE 1
Expansionary and Contractionary Elements of Current IMF Agreements
○ Indicates Expansionary Policy ● Indicates Contractionary Policy

Country:	Fiscal Policy	Monetary Policy	Public-Sector Wage Bill	Liquidity And Money Supply Growth	Interest Rates
Afghanistan	●	●		●	
Armenia	○	●		●	
Belarus	●	●	●	●	●
Bosnia and Herzegovina	●	●	●	●	
Burkina Faso	●				
Burundi	●	●	●	●	
Central African Republic	●		●		
Congo, Republic of	●		●		
Costa Rica	○	●	○	●	●
Côte d'Ivoire					
Djibouti	●	●	●		
El Salvador	●				
Gabon	●	●	●		
Gambia, The	●	●			●
Georgia	○				
Ghana	●	●	●	●	●
Grenada	●		●		
Guatemala		○			○
Haiti	○	●	○	●	
Hungary	●	●	●	●	●
Iceland					
Kyrgyz Republic	○	●	●	●	●
Latvia	●	●	●	●	●
Liberia			○		
Malawi		●		●	●
Mali	●				
Mongolia	●	●	●		●
Mozambique	○				
Niger	○				
Pakistan	●	●	○		●
Romania	●	●	●	●	
São Tomé and Príncipe	○		●	●	
Senegal	●				
Serbia, Republic of	●	○	●		○
Seychelles	●	●	●		●
Sierra Leone		●	●	●	
Tajikistan		●	○	●	
Tanzania	○	○	○	○	
Togo			○		
Ukraine	●	●		●	●
Zambia	○		○		