

At issue: **IMF policy recommendations:** *not enough change after the crisis*

IMF policy recommendations are often criticised for being too restrictive, pro-cyclical and paying little attention to country-specific circumstances. In the aftermath of the 2008 crisis, the Fund showed some policy rethinking, bringing about expectations of change. However, Rathin Roy and Raquel A. Ramos of the UNDP International Policy Centre for Inclusive Growth analyse IMF policy recommendations given to developing countries and conclude that headquarters' receptiveness to new approaches has not been translated into policy analysis or recommendations.

Our report examined the IMF policy advice given to 26 different developing countries in 2010. We relied on Article IV reports, the annual assessments the IMF makes of member countries' economies. This article summarizes the findings on four areas of policy: exchange rates, capital account regulation, fiscal policy and inflation.

Exchange rate

The 2008-2009 crisis and its two-speed recovery – developing countries recovered much faster than developed economies – resulted in major and unstable short-term capital flows to developing countries. These flows proved to be significantly destabilising, for example through the important impact they have on the value of a country's currency or exchange rate. Since movements in exchange rates have significant impacts on the real economy, the IMF advice on exchange rate issues can significantly affect people's livelihoods. As a main determinant of the competitiveness of domestically produced goods, an exchange rate appreciation potentially undermines economic activity. Moreover, sharp depreciations have immediate effects on inflation – by increasing prices of imported goods – and can lead to a severe financial crisis as they also increase the costs of servicing external debt. In this way, debates around exchange rates' desired values are directly related to issues like poverty and employment.

IMF 2010 analyses of possible exchange rate misalignment – deviations from an exchange rate consistent with the underlying fundamentals of the economy – were considerably different across developing countries. Larger emerging economies such as China, Thailand and Malaysia received detailed analyses, which included references to real developments. The analysis done for other countries, on the contrary, relied entirely on econometric exercises which have widely known flaws, such as dependence on estimations of highly uncertain variables and parameters.

Moreover, some conclusions about possible exchange rate misalignment were not based on the countries' actual figures, but rather on the expected result of a policy that the IMF was recommending which the authorities had yet not even agreed with. In the case of Botswana, the report presented the result of three approaches, which varied from a 10 per cent misalignment to no misalignment *if* “fiscal consolidation proceeds as anticipated”. Regardless of the importance of this estimated misalignment, there was no debate on policy options; implying that fiscal consolidation would be *the* policy needed to tackle the issue.

Indeed, many reports understated the exchange rate misalignment issue. This seems to have been a consequence of two practices. First, the reports considered only the averages of the different misalignment estimations, even if these often diverged significantly. Although different methodologies can, and often do, result in different estimations, the normal practice in this case is to assess which of the methodologies would be the most relevant given the country's fundamentals. Yet, such a prioritisation was not done in any exchange rate assessment. Secondly, a common practice in the IMF reports was to highlight the uncertainty related to the methodology when estimations showed an important misalignment, downplaying the misalignment issue.

In the case of Guinea-Bissau, it was concluded that estimations “do not suggest that the exchange rate is overvalued”, although they varied from 3 per cent to 21 per cent overvaluation. The downplaying of the misalignment issues meant that the reports lacked appropriate policy recommendations, or only medium-term advice was given. In the case of Cameroon, it was said that the estimated moderate exchange rate appreciation “could be corrected if the euro's current weakness is sustained”. However, to rely on the euro's path is neither a policy option nor something possible to predict. The focus of IMF recommendations was on medium-term policies, such as enhancing the “business environment”. The IMF's traditional preference for market-determined exchange rate regimes was still the rule throughout the reports. This regime was recommended even in cases where the country report had mentioned some of its negative effects in the recent periods.

As shown in the report written for Paraguay, the country often relied on interventions to avoid excessive exchange rate variability as a means to curb inflation, due to two important features of the economy. First, the exchange rate has significant impacts on inflation. Second, its monetary policies are not as effective in influencing inflation. These circumstances highlight the need to avoid excessive exchange rate volatility and of using different inflation policies. Nevertheless, the IMF advised them to avoid exchange rate interventions, to which the local authorities have answered with concerns about economic stability.

Peru is a “still highly dollarised economy” where the ongoing de-dollarisation process combined with significant and volatile capital inflows have increased exchange rate volatility. Nevertheless, the IMF recommends that the country should allow greater exchange rate variability. The country authorities, however, have mentioned concerns over this policy, adding that intervention in the exchange rate is aimed at mitigating its volatility and therefore the risks associated to a still highly dollarised economy.

Capital controls

An important part of the policy rethink seen after the crisis was related to the IMF's position regarding capital account regulations. In 2009, an IMF staff paper recognised that large capital inflows “can lead to sharp appreciations, often followed by abrupt reversals and strong effects on balance sheets”. Later in 2010, it was acknowledged that, in some circumstances, capital account regulations should be part of the policy toolkit. In 2011, a paper discussed the best design of capital account regulations in terms of effectiveness and efficiency. The IMF's policy advice on this area in 2010 would prove crucial as several countries were receiving significant capital inflows. These flows, apart from having major impacts in their economies, were subject to reversal – as happened in 2009 – risking throwing countries into banking and financial crises with severe impacts on the development and well being of their citizens.

In the case of Egypt, IMF estimations indicate an average 7.3 per cent real exchange rate overvaluation. In addition, the report clearly shows that “further real appreciation driven by short-term capital flows could

weaken medium-term growth prospects.” Still, the IMF found no problem of competitiveness and its policy recommendations do not include capital controls, focusing instead on exchange rate intervention, exchange rate flexibility and fiscal consolidation.

IMF recommendations for India on how to deal with a possible increase in capital flows are also focused on exchange rate flexibility and accumulation of reserves. The IMF also recommends “deepening domestic financial markets”, “further developing the corporate bond market” and liberalising foreign direct investment (FDI), as these would have more benefits than short-term flows. However, these policies would only lead to a decrease in short-term flows if these financial and FDI-related flows were substitutes of short-term flows. Otherwise, it would result in an increase in total capital inflows. Capital account regulations were mentioned as a *last resort only*. The Indian authorities stated that these would be considered in case flows “exceed current levels by a large margin”.

South Africa’s report presents a deeper discussion on possible policies to deal with the exchange rate overvaluation. The analysis considers, for example, that: an interest rate decrease would not be very effective, as flows are directed to stock markets; a fiscal tightening would not help to support the economic recovery; and outflow controls should be removed only gradually, given the risk of sudden outflows. However, even this deeper analysis was not in line with the IMF’s most recent position and does not consider the possibility of implementing regulation on capital inflows, on the grounds that these are claimed to be ineffective.

Fiscal policies

The IMF’s recommendations on fiscal policies have been criticised for being focused on short-term stability only, rather than on development. This short-term focus includes paying attention to efficiency issues – such as tax administration, enhancing tax collection and debt sustainability – instead of identifying policies which would enhance domestic revenue mobilisation.

Our report finds that the IMF fiscal analyses in 2010 remained significantly short-term oriented. They did not adequately consider the weak recoveries and economic prospects that hung over many countries in the aftermath of the 2008-2009 crisis. Although at this critical juncture fiscal policy could have been used to stabilise economies and solidify economic recoveries, we found the IMF to be recommending less spending. The report written for Albania clearly stated that “notwithstanding a still fragile economic recovery, fiscal consolidation is a priority”. In the case of Guinea-Bissau, although the economic outlook was said to be “subject to substantial uncertainty”, IMF conditionalities focused on tighter fiscal policies - such as a six-fold increase in government tax revenues in less than a year, downsizing the civil service wage bill and having no public external short-term borrowing.

Fiscal consolidation was also advised in cases where the reports themselves showed that there was no problem of debt solvency. In the case of Colombia, despite the positive debt analysis, the Fund argues for “more ambitious medium term fiscal targets” and recommends broadening value added tax and phasing out tax incentives for investments. The IMF also recommended that Vietnam adopt a more ambitious debt reduction plan, although the debt sustainability analysis undertaken placed “Vietnam at a low risk of debt distress” and indicated that “external debt levels would be manageable”.

Moreover, in some cases where it was unclear that the country needed fiscal consolidation but where the IMF recommended it anyway, the Fund staff argued that it would enhance the government’s credibility. For example, in Colombia’s report, a more ambitious consolidation plan “would likely improve the prospects for an upgrade from credit rating agencies”. In the case of Panama, the goal was “to bolster fiscal credibility further”. However, it is not straightforward that the debt situation of these countries – and therefore their fiscal credibility – would be enhanced in

the case of fiscal consolidation, as there was no analysis of the prospective return of the investments that would be forfeited.

The IMF recommendations also failed to prioritise domestic sources of funding. On the contrary, many countries were advised to opt for external funding based on the argument that they should take advantage of the good international funding market at the time. This potentially heightens the risk of external debt crises down the road in these countries. These recommendations were given even to countries who could obtain relatively cheap funding on domestic markets, such as Egypt and Ethiopia. The argument of cheap external funding was even used in El Salvador, which, as a dollarised economy, has domestic interest rates which are very similar to international ones.

Inflation

Many policymakers found themselves in a “challenging” position in the aftermath of the 2008-2009 crisis: as economic difficulties called for loose monetary policies such as low interest rates, higher food and energy prices were causing inflationary pressure. This situation has triggered a broad questioning of the costs of fighting inflation and of the current focus on monetary policy as the main policy instrument available to governments.

In general, IMF inflation analyses in the 2010 reports were rather superficial, mostly reduced to one or a few sentences on the inflation source – with the exception of the reports written for China and India. No debate on the costs of inflation or on the costs of fighting it was provided. Moreover, IMF policy recommendations remained highly focused on using interest rates to combat inflation. Such advice was even given to countries where the IMF had attributed inflation to supply factors, such as food prices, exchange rate movements or increases in taxes – shocks which do not respond to a monetary tightening. Exceptions were some of the larger emerging countries who, with the extra challenge of dealing with excessive capital inflows, were advised to fight inflation through fiscal policies. In the case of Jordan, the report states that “inflation is projected to increase in line with imported commodity (energy and food) prices” and advises the central bank to “tighten monetary conditions if inflation accelerates”. A similar recommendation was given to Indonesia, which, apart from having supply-side inflation, was being challenged by excessive capital inflows – two reasons why higher interest rates would not be appropriate.

In conclusion, our analysis of the IMF’s 2010 policy recommendations finds them wanting. They reflect neither the rethinking seen in economics generally, nor the apparent changes in the IMF’s position. We found that middle-income countries received deeper analyses and the IMF reports on their economies were more often presented as a debate between the IMF and country authorities. This leaves worrying conclusions about how smaller and poorer countries fare when faced with IMF recommendations and advice that may not be suitable. There are several cases where the policies advised do not seem appropriate given the country’s specific circumstances, leading us to conclude that the IMF still has a long way to go to bring its improved rhetoric down to reality at the country level.

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A fully-referenced version of this article is available at:

www.brettonwoodsproject.org/atissue80

Published by **Bretton Woods Project**
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The Bretton Woods Project is an ActionAid-hosted project, UK registered charity no. 274467
Financial support for this publication was provided by a network of UK NGOs, the CS Mott Foundation and the Rockefeller Brothers Fund.