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The IMF on Fiscal Policy: Staying the Course amidst Waves of Change

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The global crisis has prompted many reflections on economic policies and the role of international economic institutions. Whereas some changes are already in progress based on these, and others might be impending, the International Monetary Fund (IMF) was not prompt in revising its policy recommendations. With respect to fiscal policy, IMF recommendations continued on an unwavering course, although the rethinking in economic policy caused by the crisis combined with internal and external evaluations of IMF recommendations that have been implemented to create a demand for the reformulation of the IMF's approach to fiscal policy. As denoted by its 2010 Article IV reports, IMF recommendations remained steadfastly committed to a single approach to fiscal policy, one focused on short-term fiscal tightness rather than on long-term development (Roy and Ramos, 2012).

The fiscal policy recommendations in the IMF's 2010 Article IV reports lack attention to country-specific circumstances and invariably favour fiscal tightening over fiscal spending. The push for fiscal tightening is informed by a view of fiscal space as "the gap between the current level of expenditure and the maximum level of expenditures that a government can undertake without impairing its solvency" (Development Committee, 2006:14). By emphasising the short-term fiscal condition, this view neglects the broader aspects – in scope and time – of the development process. As pointed out by Roy et al. (2009), this understanding of fiscal space thus fails to acknowledge the long-term impact of fiscal spending on development objectives and future fiscal conditions.

The focus on the short-term fiscal condition evinces the prevalence of the understanding of a country's fiscal stance as both a requirement and core contributor to its macroeconomic stability and economic prospects. According to this understanding, fiscal policy better serves a country by working towards improving its fiscal condition. However, this view is not attuned to either evaluations of past IMF recommendations or current circumstances in many countries, particularly in the context of the global crisis. These underscore the fundamentally different understanding that macroeconomic stability anchored in a forward-looking fiscal space framework eclipses the short-term fiscal condition in generating the best developmental outcomes.

The inadequacy of the inexorable focus on the short-term fiscal stance in IMF reports is demonstrated by several incoherencies. First, some countries facing weak economic prospects in the aftermath of the crisis were advised to engage in fiscal tightening. Jordan was understood to have an unpromising economic outlook, which included the persistence of high unemployment, but the IMF nonetheless recommended fiscal consolidation, emphasising a reduction in public expenditures. Though adversely affected by a reduction in remittances, El Salvador and Moldova were advised to raise tax revenues and reduce spending. In the same vein, the IMF recommended fiscal consolidation to Albania and Guinea-Bissau, even though their economic prospects were considered weak and uncertain.

Second, there were reports in which fiscal consolidation was recommended, even though the country enjoyed a reasonably good fiscal situation in terms of debt-to-GDP ratio and general debt outlook. Despite its positive debt outlook, Colombia was advised to pursue further improvements in its fiscal condition to improve its ability to cope with fiscal risks, should they materialise. The advice is further supported by the argument that it would enhance the chances of a credit rating upgrade, which highlights the primacy attributed to the short-term fiscal stance vis-à-vis macroeconomic stability within a long-term developmental perspective. In the case of Vietnam, although the IMF finds it at a low risk of debt distress and recognises both the need for investments in human and physical capital and the risk of imposing a significant shock for the Vietnamese economy, it nonetheless advised the country to adopt measures to lower its debt.

Third, in the post-crisis context of cheaper external financing possibilities, the IMF recommended external borrowing in the absence of detailed risk assessments and in violation of the principle of prioritising sustainable funding sources, which advises favouring domestic over external funding, especially for countries with high exchange rate volatility. What is more, this happened even for countries with cheap domestic funding options. Egypt, with a low external debt ratio, was advised to use foreign financing to extend its debt maturity while concomitantly increasing exchange rate flexibility as a shock absorber, which nonetheless also increases external exposure. As a dollarised economy, El Salvador is exempt from exchange rate risk, but for the same reason it has access to funding at rates comparable to those in the external market, and yet the IMF urged the country to take advantage of external market conditions. In turn, Ethiopia, with cheaper domestic funding and public debt financed mainly domestically, was advised to reduce its emphasis on domestic financing.

Finally, fiscal consolidation was recommended to countries that by virtue of command over important mineral resources did not have fiscal problems. For instance, as a net creditor with perceivably low credit risk and substantial savings in its Pula Fund to protect its exchange rate regime, Botswana enjoyed a reasonably sound fiscal position. In spite of that, the IMF advised fiscal consolidation, citing a need to ensure fiscal and external sustainability, notwithstanding Botswana's need to invest in transforming its economy in preparation for times with reduced mineral wealth.

By offering fiscal policy recommendations out of sync with current circumstances as considered against the backdrop of long-term developmental trajectories, the IMF fails to play a constructive role towards either the development of individual countries or global economic stability and prosperity. To remedy that, the IMF must confront the imperative of revising its policies and positions more promptly.

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