Discussion Paper • October 2009

CENTER FOR ECONOMIC AND POLICY RESEARCH

CEPR Responds to the IMF's Reply and Defense of Its Policies During the World Recession

BY MARK WEISBROT *

The International Monetary Fund (IMF) presented a response to CEPR's latest paper, which looked at the macroeconomic policies of 41 countries that currently have agreements with the Fund. Our paper had found that 31 of the 41 countries had implemented pro-cyclical policies, that is, either fiscal or monetary policies that would be expected to exacerbate an economic downturn, when such downturns were occurring in these countries.

The IMF response was presented by James Roaf (Deputy Division Chief, Emerging Markets, Strategy, Policy and Review Department), in a PowerPoint presentation and panel discussion on October 15, 2009.[1] Most of the arguments, as well as graphs and charts, can also be found on the IMF web site,[2] and in two recent papers.[3]

The IMF's first argument is that its policies have been "countercyclical, not procyclical!" as expressed in the PowerPoint presentation. The IMF's presentation backs this up by looking at 15 emerging market countries and stating that program countries "Expanded fiscal deficits in 14 of 15" cases.[4] Similarly, the IMF's review of crisis policies in low-income countries finds that "Close to two-thirds of the programs designed in 2007-09 increased the level of spending over time."[5]

How can this be reconciled with CEPR's finding that 31 of 41 countries with current policies have implemented counter-cyclical policies? After all, we are all using the same data, which comes from IMF documents and databases.

Center for Economic and Policy Research
1611 Connecticut Ave, NW
Suite 400
Washington, DC 20009
tel: 202-293-5380
fax:: 202-588-1356
www.cepr.net

* Mark Weisbrot is Co-Director of the Center for Economic and Policy Research in Washington, DC. The author would like to thank Rebecca Ray, Jake Johnston, Jose Antonio Cordero and Juan Antonio Montecino for editorial and research assistance.

[1] For Mr. Roaf's PowerPoint presentation, and video recordings of this event, see CEPR 2009.
[2] Dohlman and Joshi 2009.
[3] See IMF 2009a and 2009b.
[4] IMF 2009b.
[5] IMF 2009a.

There are two main reasons for the competing claims. First, the IMF is ignoring its agreements that were signed in 2008, when the world economy was sliding into recession. This is when most of the 31 agreements with pro-cyclical policies were signed. As we acknowledged in our paper, in many cases the pro-cyclical policies, such as reducing the fiscal deficit, were later loosened. However, since there are up to four to six months, and sometimes longer, before such agreements are reviewed, the decision to tighten fiscal and/or monetary policy during the downturn can still be expected to cause damage.

Second, the IMF's response to CEPR's paper, as well as its own papers, did not deal with monetary policy, but instead was limited to fiscal policy. Although 14 of the 31 countries where pro-cyclical policies were found had both pro-cyclical fiscal and monetary policies, there were seven countries that only had pro-cyclical monetary policy. In many cases, tightening monetary policy during an economic downturn can be at least as damaging as tightening fiscal policy.

This decision to tighten fiscal and monetary policy during an economic downturn in 31 countries represents a significant policy mistake, and a continuation of a long-term policy bias toward overly-restrictive fiscal and monetary policies, for which the IMF has been subject to criticism – some coming from its own Independent Evaluation Office[6] - over many years. The Fund should therefore acknowledge these mistakes, rather than trying to paper them over, and take measures to make sure that they do not happen again.

This is especially important in light of the uncertainties surrounding the recovery of the world economy next year. As the IMF's latest World Economic Outlook notes,[7] there are many downside risks with regard to the expected recovery of the world economy next year. This is especially true of the US economy, which accounts for about one quarter of world GDP. The fiscal stimulus that has been allocated for 2009, for example, is a small fraction – perhaps about one-tenth – of the falloff in private demand that could be expected from the collapse of the U.S. housing bubble.[8] It is not yet clear whether the Congress will provide additional fiscal stimulus.

Given the acknowledged downside risks to the recovery, it is important in the IMF's reviews of current agreements, as well as new ones, that it err on the side of caution. As the Federal Reserve of the United States has pledged to do, it should be careful not to hobble the recovery by premature tightening of monetary policy, or fiscal policy as well.

6 IEO 2003a.
7 IMF 2009c.
8 See Baker and Deutch 2009. In the current WEO, the IMF, to its credit, looks at housing prices and bubbles internationally. For the United States, the WEO concludes that further corrections in the U.S. "are likely to be small." (pg. 23). However, U.S. house prices, which are currently being supported by federal subsidies to homebuyers, are likely to need to fall significantly before reaching a sustainable level (see Baker 2009).

When is Fiscal Policy Counter-cyclical or Pro-cyclical?

Another important issue that came up in this discussion is the definition of pro-cyclical fiscal policy. In our paper on the IMF's current agreements, we adopted a criterion that was overly conservative – that is, it did not count as pro-cyclical some fiscal policy stances that would be widely seen as such, for example in the United States.

In our paper, we only counted as pro-cyclical fiscal policy cases where the fiscal deficit was programmed to narrow (or surplus to increase), while the economy was in a downturn. This was done for the sake of argument, and also because we did not have access to data that would allow a calculation of the structural fiscal balance (see below). When the IMF states that program countries "Expanded fiscal deficits in 14 of 15" cases, and cites this as evidence of "Countercyclical, not Procyclical!" policy,[9] it is limiting the definition of pro-cyclical to those cases where the fiscal deficit narrows during a downturn.

However, this definition is too narrow. Suppose, for example, that the economy is at full employment and is running a balanced budget. Economists would call this a structural fiscal balance of zero. Then, as the economy slows or heads into recession, revenues fall. The budget is now in deficit, but the structural balance remains at zero. The government has not adopted any counter-cyclical fiscal policy.

Now suppose that there are automatic stabilizers on the spending side. For example, in the United States, spending on federal programs such as food stamps, unemployment insurance, and other aid will automatically increase as the economy heads into recession. The government could reduce these benefits in order to cut off some of the increase in spending that would otherwise happen automatically. Thus, it could tighten the eligibility requirements, or size or duration of benefits for the unemployed or poor.

In this case, the budget deficit would still widen because of the lost revenues and possibly even increased spending. Yet this would hardly be considered counter-cyclical policy[10] – certainly not in the United States. In fact, there would be quite a political backlash in the U.S. if our government tried to cut social programs in this way during a recession (the U.S. government has done the opposite in the current recession, for example by extending unemployment benefits and covering part of unemployed workers' health insurance).

Thus, any widening of the fiscal deficit during a downturn or recession should not necessarily be counted as counter-cyclical fiscal policy.

---

[9] IMF PowerPoint presentation, CEPR 2009.

[10] In the economic terms defined above, the structural balance would have gone from zero to a positive number, thus indicating a pro-cyclical policy.

In the IMF paper "Review of Recent Crisis Countries" last month, the Fund states:

> "Deficits were allowed to rise in response to falling revenues and, in cases where domestic and external financing was lacking, this was facilitated by channeling Fund resources directly to the budget. **In many instances, however, underlying concerns about debt sustainability and weak structural fiscal positions required limiting the full play of automatic stabilizers**." (IMF 2009c, 3, emphasis added).

This is an acknowledgement that in "many" of the 15 countries reviewed in this paper, the full spending increases that would have automatically occurred during a downturn were not allowed. In other words, this is comparable to the U.S. government having cut food stamp eligibility or benefits, or done the same of other social programs, during the current recession – which would not be considered counter-cyclical policy here.

The countries where this occurred are shown in Figure 16, page 25 of its Review. This list turns out to include eight of the 15 countries reviewed in the paper: Ukraine, Belarus, Romania, Serbia, Bosnia and Herzegovina, Hungary, Mongolia and Pakistan. Thus, when the Fund says that there are "Expanded fiscal deficits in 14 of 15 cases," it is ignoring that in eight of these cases, the governments actually tightened their fiscal stance, reducing the impact of automatic stabilizers. Therefore, by a more common economic definition these governments adopted a contractionary, pro-cyclical fiscal policy. It would be good if the Fund did this calculation for all of its borrowing countries.

The IMF's "Review of Recent Crisis Countries" also notes that only four of the 15 countries "are expected to expand spending in real terms in 2009." Furthermore the IMF finds that "Program countries show larger real spending cuts than non-program countries."[11]

The Fund should support counter-cyclical policies that actually increase government spending, during a downturn, beyond what would be provided by automatic stabilizers. That is how the United States and other high-income countries have responded to the current recession. If there is some reason that this is not possible in a particular country, the Fund should provide a clear explanation of why it is not possible, even with the help of loans from the IMF. This would include not only the countries mentioned above, but also seven countries that, as the IMF acknowledged in its PowerPoint presentation last week, have contractionary fiscal policies according to its own more narrow criterion, in their latest reviews.[12]

Latvia

The case of Latvia was discussed in our previous paper and in the panel discussion. As noted previously, [13] it is important because it is a case where the economy has been sacrificed – in fact, devastated – in order to preserve a fixed, overvalued exchange rate – as was the case in Argentina from 1998-2002.

---

[11] See IMF 2009b, 24.
[12] CEPR 2009.
[13] See Cordero 2009.

This policy, supported by both the IMF and the European Union, must be judged a failure on its face, without any necessity for counterfactual comparisons. The IMF projects Latvia's real GDP to fall by 18 percent this year. The magnitude of this contraction is rare in modern economic history (outside of war), even in the worst financial disasters of the past century. A recent paper by Carmen Reinhart and Kenneth Rogoff looked at 14 severe financial crises.[14] The only declines greater than 18 percent are Argentina (-22 percent), which occurred over the four years 1998-2002; and the US in the Great Depression, a 29 percent drop that also occurred over four years. An 18 percent decline in one year therefore indicates a major policy failure in dealing with the crisis, regardless of the mistakes that led up to it, and despite the fact that Latvia's banking system did not (as of this writing) collapse. This indicates that even if the balance sheet effects of a currency devaluation – avoided in Latvia – were large, it would still have been better to deal with that problem rather than to undergo such a severe economic contraction, adopting pro-cyclical policies which have no doubt exacerbated it – in order to avoid devaluation.

Standards of Comparison

In its two published reviews and last week's panel discussion, the Fund also defended its policies during the current downturn with comparisons to past crises, most notably the Asian economic crisis of 1997-1999 and others during the late nineties and early 2000s. The Fund points out that the huge interest rate spikes and exchange rate overshooting of past crises were avoided. This is true, and the IMF can note improvement in its policy recommendations on this account. However, this is much too low a bar. In the Asian crisis, the IMF was widely seen to have seriously exacerbated the downturn, and in fact the IMF's Independent Evaluation Office conceded that "[I]n Indonesia . . .the depth of the collapse makes it difficult to argue that things would have been worse without the IMF. . ."[15] The Fund's role in Argentina's crisis of 1998-2002 is also one of the worst episodes in its lending history; and in fact the IMF did not provide any net lending after the banking system and currency collapsed at the end of 2001.[16]

The Fund also presents a regression and scatter-plot diagram[17] in support of the argument that, although IMF program countries had much steeper declines in GDP than non-program countries, these differences were due to initial conditions and not to program effects. It is difficult to evaluate such results without more information about the analysis, including the data. However, we believe that IMF economists would agree that the econometric difficulties with this particular regression are enormous, and that it cannot be considered as any kind of conclusive evidence that the programs "worked." Furthermore, this is also too low a bar, since even if the evidence from this regression were compelling, it would only show that the IMF programs did not have a net harmful effect. In fact, we would want and expect the IMF programs, and access to foreign exchange, to have a positive net impact on borrowing countries.

The Fund also defends its initial, mostly 2008 agreements containing pro-cyclical policies on the grounds that their projections were over-optimistic. As discussed in our previous paper, [18] by the time of IMF's bad projections, there was plenty of available information and analysis to indicate that

[14] Reinhart and Rogoff 2009.
[15] IEO 2003a, 38.
[16] See Weisbrot and Sandoval, 2007.
[17]IMF PowerPoint presentation, CEPR 2009.
[18] See Weisbrot et al. 2009.

the impact of the U.S. and high-income countries' recession on low-and-middle-income countries would be severe. As noted above, the Fund now recognizes that asset bubbles should be taken into account when formulating economic policy.[19] But the problem of overly optimistic projections in conjunction with overly tight macroeconomic policy is one that has been noted before, not only by CEPR[20] but also by the IMF's Independent Evaluation Office:

> The report also finds evidence of weaknesses in program design in certain areas. There is a tendency to adopt fiscal targets based on overoptimistic assumptions about the pace of economic recovery leading inevitably to fiscal underperformance and frequent revisions of targets. The optimism about growth recovery in the short term is itself often the consequence of overoptimistic assumptions about the pace of revival of private investment when a more realistic assessment in certain circumstances could have justified the adoption of a more relaxed fiscal stance on contracyclical grounds. (IEO 2003b, vii).

We look forward to further discussion of IMF agreements and policy as the world economy recovers, and more loan agreements and reviews of current agreements are concluded.

---

19 See *IMF Survey Magazine* 2009. See also the latest WEO, which has several pages on real estate bubbles in various countries (IMF 2009c, 20-26).

20 See Baker and Rosnick 2003 and Rosnick and Weisbrot 2007.

References

Baker, Dean. 2009. "Housing Market Monitor: Mortgage Applications Surge as Homebuyers Seek to Benefit from Tax Credit." Center for Economic and Policy Research, October. http://www.cepr.net/index.php/data-bytes/housing-market-monitor/mortagage-applications-surge/.

Baker, Dean and David Rosnick. 2003. "Too Sunny In Latin America? The IMF's Overly Optimistic Growth Projections and Their Consequences." Center for Economic and Policy Research Briefing Paper, September. http://www.cepr.net/documents/publications/econ_growth_2003_09.pdf.

Baker, Dean and Rivka Deutch. 2009. "The State and Local Drag on the Stimulus." Center for Economic and Policy Research Briefing Paper, May. http://www.cepr.net/documents/publications/stimulus-2009-05.pdf.

Carmen M. Reinhart, Carmen M. and Kenneth S. Rogoff. 2009. "The Aftermath of Financial Crises." *American Economic Review 99* (May) 466-472. http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf.

Center for Economic and Policy Research (CEPR). 2009. "Event: IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-One Borrowing Countries." Panel discussion, October 15. http://www.cepr.net/index.php/events/events/imf-supported-macroeconomic-policies-and-the-world-recession/.

Cordero, Jose A. "The IMF's Stand-by Arrangements and the Economic Downturn in Eastern Europe: The Cases of Hungary, Latvia, and Ukraine." Center for Economic and Policy Research Briefing Paper, September. http://www.cepr.net/documents/publications/imf-2009-09.pdf.

Dohlman, Peter and Bikas Joshi. 2009. "Reformed IMF Lending Has Worked Well In Crisis." *IMF Survey Magazine*. September 28. http://www.imf.org/external/pubs/ft/survey/so/2009/POL092509A.htm.

IEO (Independent Evaluation Office of the IMF). 2003a. "Evaluation Report IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil." September. http://www.imf.org/external/np/ieo/2003/cac/.

IEO (Independent Evaluation Office of the IMF). 2003b. "Fiscal Adjustment in IMF-Supported Programs." September. http://www.ieo-imf.org/eval/complete/pdf/09092003/all.pdf.

IMF. 2009a. "Creating Policy Space—Responsive Design and Streamlined Conditionality in Recent Low-Income Country Programs." September. http://www.imf.org/external/np/pp/eng/2009/091009a.pdf.

IMF. 2009c. "Review of Recent Crisis Programs." September. http://www.imf.org/external/np/pp/eng/2009/091409.pdf.

IMF. 2009c. "World Economic Outlook: Sustaining the Recovery." October. http://www.imf.org/external/pubs/ft/weo/2009/02/index.htm.

IMF Survey Magazine. 2009. "Quick, Forceful, Cooperative Action Needed on Crisis—IMF." October 9. http://www.imf.org/external/pubs/ft/survey/so/2008/new100908a.htm.

Rosnick, David and Mark Weisbrot. 2007. "Political Forecasting? The IMF's Flawed Growth Projections for Argentina and Venezuela." Center for Economic and Policy Research Briefing Paper, April. http://www.cepr.net/documents/publications/imf_forecasting_2007_04.pdf.

Weisbrot, Mark and Luis Sandoval. 2007. "Argentina's Economic Recovery: Policy Choices and Implications." Center for Economic and Policy Research, October. http://www.cepr.net/index.php/publications/reports/argentinas-economic-recovery-policy-choices-and-implications/

Weisbrot, Mark, Rebecca Ray, Jake Johnston, Jose Antonio Cordero and Juan Antonio Montecino. 2009. "IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-One Borrowing Countries." Center for Economic and Policy Research Briefing Paper, October. http://www.cepr.net/documents/publications/imf-2009-10.pdf.