THE IMF'S ADVICE ON FISCAL POLICY

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Axel Schimmelpfennig talks IMF fiscal policy advice.

The International Monetary Fund (IMF) is a global institution with a membership of 188 countries. One of the IMF's tasks is to provide fiscal policy advice to its members. Given the centrality of fiscal policy for every country, it is no wonder that such advice can be controversial at times. This article reviews how the IMF's fiscal policy advice has evolved over time, learning from experience and research.

Fiscal policy is one of the main tools at the government's disposal to influence the wellbeing of its citizens. Government spending provides schooling, clinics, infrastructure and many other essential services. Taxation takes money from citizens to pay for these expenditures. By providing fiscal stimulus, fiscal policy can play a role in mitigating recessions and thus job losses.

Fiscal policy can also, when spending is not matched by revenues, lead to a build-up of debt that may become difficult to repay. In this case, adjustment may be required, which might include fiscal austerity.

SOME USEFUL CONCEPTS

Before diving into the discussion of fiscal policy and the IMF's advice, it is useful to recall a few key concepts that are often referred to in this context.

Solvency. A country is "solvent" if it has enough current and future revenue to repay its debt. This money could be raised from taxes, but could also come from the sale of natural resources or government property, including through privatisation. Why is this important? People will only lend money to a country today if they are comfortable the country can pay them back in time and is thus creditworthy.

Liquidity. Even if a government is solvent, it may be illiquid. Being illiquid means that a government cannot make a debt repayment falling due, even though it will have enough money in the future to repay the debt in full. An analogy would be a household that cannot make a mortgage payment in one month because it had to pay an unexpected hospital bill. In the following months, without such an unexpected payment, the household could repay the mortgage in full. Why is this important? Because one person's debt repayment is another person's income. If a debt repayment does not come in, the creditor faces a loss of income.

Sustainability. The concept of debt sustainability provides a larger context. Can a government repay its debt, can it make each repayment at the right time, and can it do so while delivering on all policy commitments without changes to the tax system? Slightly more technically: is the projected tax revenue from existing taxes sufficient to cover all spending on debt service, education, health, social transfers, government wages, government investment, etc.?

When the IMF addresses fiscal policy, sustainability is a key concept. It helps us assess how much *fiscal space* a country has. This is the room to manoeuvre the government can use to implement new spending programmes, reduce the tax burden, or support economic activity during a downturn.

STIMULUS AND AUSTERITY

Fiscal policy can help stabilise economic activity. Economic activity takes place when one party demands a good or a service, and another party produces that good or service. There are times when consumers and investors do not demand as many goods or services as the country can produce. Economic growth slows or turns negative, and in most cases, people lose their jobs. In response, the government can step in, for example, by buying domestically produced goods and services. The demand shortfall from the private sector is at least partially made up, economic growth does not slow by as much, and fewer jobs are lost. This is the fiscal stimulus, a shot in the arm for the economy. Of course, in a situation where private demand is higher than the domestic economy can supply, the government should reduce its purchases and thus help align demand with supply. Taken together, this is the essence of counter-cyclical fiscal policy, a policy that tries to stabilise economic activity over the business cycle.

Fiscal policy is not the only policy tool a country has available to stimulate economic activity. The other main tool is monetary policy. For example, by lowering its so-called "policy rate", a central bank can reduce the cost of borrowing and thus entice firms to invest more.

Fiscal austerity is the opposite of fiscal stimulus. The government cuts spending or increases taxes, thus reducing the demand for domestic goods and services, which can lead to a slowdown in growth. Why would a government ever need to resort to fiscal austerity? Sometimes, governments find themselves in a situation where they have over-borrowed. They become illiquid or even insolvent. Different paths can lead to such a situation. The government may have taken on so much debt that it struggles to repay and maintain all spending programmes without raising additional revenue. Or an adverse shock may have hit the country, reducing the government's revenue: for example, a sharp decline in commodity prices for a commodity exporter. In these cases, the government is running out of fiscal space, it spends more than it takes in, and ultimately needs to find a way to bring spending and revenues in line again.

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High debt levels are costly. In a 2013 blog, the IMF's chief economist Olivier Blanchard explains two costs that he considers particularly important. The higher the debt, the higher the interest governments have to pay when they borrow, leaving less money for other spending priorities. Higher government borrowing costs also push up private sector borrowing costs and thus weigh on investment and consumption.

In all of this, there is an important difference between growth in a particular year and a country's long-term growth potential. Fiscal stimulus and austerity impact growth in a particular year by adding or taking away from domestic demand. However, they do not impact the long-term growth potential, which is mainly determined by a country's endowment with natural resources, its institutions and, last but not least, the skills of its people. The long-term growth potential can, for example, be raised through reforms that improve schooling or health, or make it easier for the private sector to do business. There is an important connection between structural reforms and fiscal stimulus or austerity. Combining fiscal stimulus with growth-enhancing reforms can yield a double boost. And combining fiscal austerity with growth-enhancing reforms can mitigate the negative impact on today's growth.

The IMF's fiscal policy advice is closely related to the history of economic thought on fiscal policy. As with many institutions in different fields, the IMF looks to academic research as a key input for its work. In addition, the IMF carries out its own research to inform its policy advice. The IMF's chief economist is usually a top academic in the field of macroeconomics.

Macroeconomists have directed a large share of their research to the question of what governments can do and should do so that their countries can enjoy strong growth, full employment and high living standards. The answer has differed over time. In the 1930s, against the backdrop of the Great Depression, John Maynard Keynes argued that governments and central banks play a pivotal role in stabilising economic activity over the cycle, including protecting jobs during downturns. A couple of decades later, academics started to doubt whether fiscal stimulus was actually effective in supporting economic activity in the real world, or whether it simply led to a build-up of debt without any positive impact on growth and jobs. Instead of fiscal policy, monetary policy was seen as the better instrument to manage economic fluctuations over the cycle. In the context of the global financial crisis, » academic thinking evolved further. Faced with the risk of a repeat Great Depression, monetary policy was quickly running out of ammunition, and fiscal policy had a role to play.

THE IMF'S THINKING ON FISCAL POLICY

How does the IMF fit into this discussion? The IMF has three main mandates: to monitor economic developments and give policy advice, to provide emergency financing to countries in an economic crisis, and to provide technical assistance on specific macroeconomic issues. The first two of these mandates are intrinsically interlinked with fiscal policy. Fiscal policy advice is, of course, a major component of the IMF's overall macroeconomic policy advice. In an economic (debt) crisis, fiscal policy more often than not is a main pillar of the policy package intended to move a country out of crisis. Indeed, some quip that IMF really stands for "It's Mostly Fiscal".

Fiscal policy is often a main pillar of a crisis management package because crises either have a fiscal root or an impact on fiscal sustainability. An example of a fiscal root is when a government has taken on too much debt and has become either illiquid or insolvent. Nobody is willing to lend to the government anymore. Faced with a cash shortfall, the government either needs to cut spending or raise taxes. An example of a crisis with fiscal consequences is a situation where a number of large banks fail and need to be bailed out by the government to protect small depositors who are at risk of losing their savings. This increases government debt, possibly to a level that is no longer sustainable.

In the past, the IMF's fiscal policy advice was influenced by two factors. First, many economic crises were debt crises where governments had taken on too much debt. Second, the IMF, in line with the mainstream academic research, did not believe that, in practice, fiscal policy was very effective in stimulating economic activity, partly because it is difficult to time the stimulus right when recessions are short-lived. Instead, monetary policy, which can be fine-tuned more easily, was seen as the more potent tool.

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The 1997–98 Asian crisis highlighted a crucial problem with this single-minded focus on restoring fiscal sustainability as quickly as possible. As we have seen, fiscal austerity hurts growth further. Thus, in a vicious circle, too much fiscal austerity may not succeed in reducing the debt-to-GDP ratio because GDP – the gross domestic product – declines faster than the debt; moreover, when GDP declines, government revenue also shrinks. The experience showed that fiscal austerity, even where necessary, had to be carefully calibrated to avoid becoming self-defeating. Moreover, it would have to be accompanied by other policy reforms that would boost growth.

The global financial crisis of 2008 had two elements that differentiated it from past debt crises. First, the origin of the crisis was in the banking sector and not linked to fiscal policy mistakes. The IMF knew from its research that banking crises are often more severe and prolonged than public debt crises. Second, most governments had their fiscal house in order, meaning that public debt levels were fairly low and provided room to manoeuvre. The world was faced with a severe crisis, and monetary policy on its own –especially with a financial system that needed repair – was unlikely to be sufficient to prevent massive output and job losses. There was the clear need and the space for bold policies to prevent a repeat of the Great Depression.

Consequently, the IMF's November 2008 World Economic Outlook Update was titled "Rapidly weakening prospects call for new policy stimulus" and argued that "(t)hese are conditions where broad-based fiscal stimulus is likely to be warranted. Fiscal stimulus can be effective if it is well targeted, supported by accommodative monetary policy, and implemented in countries that have fiscal space".[1]

The IMF's April 2009 World Economic Outlook backed this up with research, concluding that, "[i]n view of the extent of the downturn and the limits to the effectiveness of monetary policy, fiscal policy must play a crucial part in providing short-term stimulus to the global economy. Past experience suggests that fiscal policy is particularly effective in shortening the duration of recessions caused by financial crises".

Thus, the IMF, together with the G20 nations, advocated fiscal stimulus. Across the world, governments successfully implemented such counter-cyclical fiscal policy, from advanced economies to emerging markets and low-income countries. This was a remarkable feat of global policy coordination that prevented the worst.

Many low-income countries were negatively hit by the global financial crisis that came on top of the 2007 commodity price shock. As a result, spending needs were large and were estimated to exceed available financing. The IMF responded in 2009 by increasing the financial resources available to low-income countries, making financing available at a zero interest rate, and adapting its fiscal policy advice. In particular, the IMF placed a strong emphasis on poverty alleviation and growth in its lending programmes, for example, by including a floor on social spending on areas like health, education, or support to the poor. For this to work, IMF lending arrangements accommodated increased fiscal deficits and often higher spending to meet the challenges of the food, fuel and global financial crisis.

The experience during the global financial crisis, however, does not mean that fiscal austerity cannot become necessary in individual cases. Where a government has build up an excessive debt burden, the choice is either to default – and thus be cut off from financial markets for a prolonged period of time – or to adjust.

Even in these cases, though, IMF policy advice is very cognisant of the need to promote growth. This means, first and foremost, that the design of fiscal austerity needs to be right. Spending on social safety nets, on education, on health, on public investment, and, more generally, spending that either directly impacts citizens' well-being or future growth prospects should be protected as much as possible. It is particularly important to protect the poor and vulnerable groups of society. Moreover, a successful reform package has to include measures to boost long-term growth that can range from strengthening education to eliminating red tape or alleviating infrastructure bottlenecks.

Over time, the IMF's policy advice has thus become more nuanced and more attuned to specific circumstances, and has evolved as our understanding of economic relationships improved. One area of current focus for the IMF is public infrastructure investment. In the October 2014 World Economic Outlook, we advocated scaling up public infrastructure investment, finding that its impact on growth outweighed the associated borrowing costs. As the IMF's Managing Director Christine Lagarde recently summarised: "Fiscal policy needs to be calibrated to the strength of the recovery, without losing sight of debt sustainability over the medium term."

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THE CASE OF SOUTH AFRICA

The IMF's policy advice to South Africa over the last few years is a good example of how advice is targeted to specific circumstances, while also adapting with our changing understanding.

As with most other countries, South Africa experienced an adverse shock from the global financial crisis when demand for the country's exports declined sharply. This led to a brief recession and the loss of about one million jobs. Through years of fiscal prudence, South Africa had reduced government debt to below 30 percent of GDP by 2007, and thus had ample fiscal space to provide stimulus. And this is exactly what the government did, and which was recognised in the IMF's reports on South Africa.

However, year after year, growth did not recover and remained lower than before the crisis. The government continued to provide fiscal stimulus, and government debt increased steadily, eventually leading to downgrades by the rating agencies and some signs of concerns from investors.

The question arose whether the growth decline was really cyclical or whether something else had happened and South Africa's growth potential had declined. IMF research – as well as research by the South African Reserve Bank and the National Treasury – found that the country's growth potential had declined. Before 2008, growth averaged 3.5 percent per year, but over the last few years that average has declined to 2–2.5 percent. This fundamentally changes the assessment of fiscal policy: fiscal stimulus can effectively boost growth in a cyclical downturn, but it can do little to raise a country's long-term growth potential.

In light of these findings, Finance Minister Nhlanhla Nene, in his October 2014 medium-term budget policy statement and the February 2015 budget, announced a strategy of fiscal consolidation, spread over the three-year forecast horizon, to stabilise the government's debt ratio. At the same time, the reforms outlined in the National Development Plan should, when implemented, raise South Africa's long-term growth prospects and bring down the high levels of unemployment.

The IMF's fiscal policy advice has evolved over time, learning from past experiences and mistakes, as well as academic and in-house research, and our thinking will continue to e volve and adapt. Since the onset of the global financial crisis, we have hosted three major conferences on rethinking macroeconomic policies (in 2011, 2013, and earlier this year), bringing together leading policymakers and academics in the quest to provide the best advice possible. NA

NOTE

1. All IMF publications mentioned in this article can be downloaded for free at www.imf.org. South African Treasury documents are available at www.treasury.gov.za.