LEAVING MUCH UNSAID

A RESPONSE TO "THE IMF'S ADVICE ON FISCAL POLICY"

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A response to Axel Schimmelpfennig, the IMF senior representative in South Africa, whose article was featured in New Agenda *Issue 58*

The International Monetary Fund (IMF) has undergone a profound intellectual transformation over the last ten years. Whether this was caused by the 2008 global financial crisis or only accelerated by it is difficult to tell. What is clear is that the Fund's research department, the former experts in the art of paradigm maintenance, have become adherents – even leaders – of a subtle, fact-based and context-sensitive economics. The result has been a growing stream of publications that are astounding to anyone accustomed to the IMF of the 1980s through the early 2000s. Taking just a few of the more prominent findings published by the Fund or its staff:

- "Trickle down" economics does not work; that is, lower inequality does not come at the expense of growth, and high levels of inequality are negative for growth (Dabla-Norris,

Kochhar, Suphaphiphat, Ricka and Tsounta, June 2015).

- Public spending has multiplier effects, in particular when monetary policy has reached its lower bound, and so cuts to spending can cause significant economic harm (in a range of publications from 2008, most recently the World Economic Outlook 2014).
- Intervention in foreign exchange and currency markets can be effective, and, when there is a "disorderly adjustment" in capital flows, capital controls can be valid(Blanchard, Adler and Filho, July 2015).
- Labour market liberalisation has a negative short-term impact on productivity and at best a neutral long-term effect, in particular under conditions of tight monetary policy (World Economic Outlook, Chapter 3, April 2015).
- The most beneficial structural reforms tend to be more aggressive intervention to increase competition in product markets, and greater public investment in skills and research and development (R&D) (ibid.).
- Levels of unionisation have little to no effect on unemployment or economic growth, but reducing union strength does increase inequality (Jaumotte and Buitron, March 2015).
- The private property rights of "hold out" bondholders can be violated in a restructuring of distressed government debt, as in Argentina and Ukraine (IMF Staff Paper, September 2014).

Some of these research-based shifts in outlook and advice are reflected in the article by Dr Schimmelpfennig. For example, running fiscal deficits in the aftermath of the global financial crisis is not condemned, as one might have expected from the IMF in the era of structural adjustment. Of particular note is the emphasis on investment in deficit-funded infrastructure and social safety nets for the poor as valuable, in fact desirable, forms of stimulus.

In that light, however, it is disappointing that the comment did not take the natural next step of questioning whether that is what South Africa's fiscal deficit has in fact paid for. If there is one lesson of the research by the IMF and others into austerity and fiscal spending, it is that the composition of spending can matter as much or more than its level. In an economy characterised by low savings and investment, high consumption and a high current account deficit, fiscal stimulus weighted towards yet more consumption will clearly be less effective than one weighted towards investment. Yet our post-2008 deficits were fuelled by higher public wages and lower taxes: that is, they were weighted in precisely the wrong direction.

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The comment not only leaves this unsaid but, in not tackling it, goes on to make a false inference. If a badly structured fiscal stimulus did not generate growth, it does not follow that no fiscal stimulus will generate growth. It is similarly a straightforward mistake to state, as the article does repeatedly, that fiscal stimulus does not affect long-term growth potential. This is the case if the stimulus operates through consumption, via the public wage bill and tax cuts. It is not the case if the stimulus concentrates on infrastructure and skills.

A more troubling set of omissions relates to tax policy. The article is cautious in its use of language, except when it comes to creditors and taxes and value judgements proliferate. Upfront is a normative treatment of creditors' rights *vis-à-vis* a public sovereign, in the statement that "one person's debt repayment is another person's income". There follows a statement that debt sustainability should be analysed "without changes to the tax system", and the tax "burden" is discussed exclusively in the context of its "reduction".

This implicit bias persists through the remaining sections, in which tax rises are put to one side, and higher debt is a straightforward negative. The asset side of the public balance sheet is ignored, as are domestic savings and liquidity, the financial system, and a host of other factors. Leaving those out leads to the quite remarkable statement is that "the higher the debt, the higher the interest governments have to pay." This is flatly contradicted by the experience of the entire developed world at present, from the near-zero yields on Japan's debt (six *times* South Africa's), to the fact that US Treasury yields are rising precisely when US deficits are coming down. Among developing countries, finding a correlation between debt levels and interest rates requires leaving out so much else of importance

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A similarly peculiar statement is that failing banks may "need to be bailed out by the government to protect small depositors". Little could be further from the truth. Small depositors are protected by deposit insurance schemes, where such exist. Bank bailouts occur to protect large institutional creditors - or banks that have successfully fought off the expense of an insurance scheme. It is curious that the IMF itself has called for deposit insurance in South Africa in its Financial Sector Stability Assessment (FSSA) in December 2014, but that call is absent here. It might be argued that the article focuses on fiscal policy, but, when highly concentrated in a small number of "too big to fail" banks, as Spain, Ireland and the UK have shown, the financial system can be by far the largest risk to fiscal headroom.

This brief survey of what is left out could easily be expanded. The IMF's most recent Article IV assessment of South Africa makes important points about low consumption taxes, dangerously low levels of foreign exchange reserves (only Ukraine is more vulnerable than we are), and, in particular, breaking open the monopolies and cartels in our product markets, transport and finance. Nodding towards the laundry list that is the National Development Plan (NDP) is a poor substitute, especially when the one item not on that list is more aggressive competition policy.

In sum, the article might be said to land somewhere in a disappointing middle. Implicit biases aside, it is not, like the Fund's actions in Greece earlier this year, a wilful disregard by the mission staff of the research department's work. It provides a good overview of why fiscal austerity is harmful, points out that our fiscal stimulus was not successful in the way it was structured, and shows that we need both a better fiscal balance and deeper reforms.

However, it avoids spelling out the implications of the IMF's own research, not only through its global research, but inherent in the Fund's own recent consultations and reports on South Africa. Combining the research listed at the outset with the facts in the Fund's most recent FSSA and Article IV, four such implications are clear:

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- first, that effective "structural reform" means making private and public monopolies and cartels vulnerable, not making workers vulnerable. Labour market reform is not a panacea, and is probably ineffective. Competition policy is much more important, especially in key product markets and the financial sector
- second, that the fiscal and tax structures need to rebalance aggressively and quickly towards investment and away from consumption. Investment should be in skills and R&D as well as infrastructure; the bias against consumption can operate both through restraining the public wage bill and higher consumption taxes
- third, that our "fiscal headroom" is dangerously exposed to overly large, connected banks with high capital but low liquidity buffers, in the absence of a deposit insurance scheme to cope with a bank failure or national reserves sufficient to deal with a "sudden stop"
- fourth, that, given our levels of inequality, we need to maintain or extend the progressivity of our tax system, and should reject as unsubstantiated the argument that increasing marginal taxes at higher income levels will negatively affect growth. It may be asking too much for the Fund to be this explicit. Aside from its formal documents, it tends to be cautious in public articles. Moreover, its principal interlocutors here are Treasury and the Reserve Bank. The latter has become, remarkably, a redoubt of the dogma that the IMF itself has largely discarded. In the latest Article IV, the Reserve Bank is reported, implicitly and at times explicitly, to reject increasing foreign exchange reserves, any deviation from the dogma of fully flexible exchange rates, and increasing competition in the financial sector.

So the caution in the article may simply be one more symptom of the more general cause of our policy paralysis: namely the capture of our institutions by opposing, evidence-immune intellectual factions. Rather than an excuse, that diagnosis is an injunction. By making clear how far it has moved, the Fund's most valuable contribution to our policy debate may be to make clear how hidebound we have become. NA