

# Failed Policy: The IMF in Crisis

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TIMOTHY SHARPE, AUG 21 2012

The resignation letter of Peter Doyle, a senior IMF economist, has added to recent controversy surrounding the embattled Fund. While reports of 'suppressed' policy advice are telling, unfortunately it's of no real surprise and will not disrupt the IMF's policy agenda. Notwithstanding the nature and causes of the Global Financial Crisis (GFC), the IMF continues to espouse fundamentally flawed policy advice, as the institution seeks to maintain its relevance and legitimacy despite becoming largely redundant following the collapse of the Bretton Woods (fixed exchange rate) system in 1971.

### Background, crisis and rhetoric

The International Monetary Fund (IMF) was established in 1944, at Bretton Woods, 'to engender postwar economic growth', 'prevent a relapse into autarky [closed economy] and protectionism', and to facilitate the international payment system in the context of fixed exchange rates (Boughton, 2004:5, quoted in Sharpe and Watts, 2012). Following the collapse of the Bretton Woods system, many economies transitioned to a flexible or floating exchange rate regime which allowed the foreign exchange market to determine a currency's value and therefore eliminate the *need* for intervention by policymakers. Consequently the IMF sort to reinvent its operations, focusing more on policy advice and so called 'surveillance'.

Neo-liberal economic policies began to gain traction among policymakers during the 1970s, and have since dominated the mainstream discourse. IMF policies echoed the paradigm shift whereby, active fiscal (government) policies to promote growth and reduce unemployment was replaced by the neo-liberal free-market approach which included deregulation and privatisation policies, and monetary policy geared to low-inflation (Sharpe and Watts, 2012). In essence, the policy consensus became one of 'sound' fiscal management rather than 'functional' fiscal policy (see Forstater, 1999). Since this time, the effective use of monetary policy has largely dominated the IMF's discourse, with discussions of fiscal policy reduced to notions of discipline and sustainability.

The GFC marked 'the worst global downturn since the Great Depression' (IMF, 2012). IMF (2012) concedes that the Crisis 'uncovered a fragility in the advanced financial markets.' It is interesting to note, in the aftermath of the Asian Financial Crisis (1996-7), the IMF allegedly 'drew several lessons that would alter its responses to future events.' Of these, the Fund realised that 'it would have to pay much more attention to weaknesses in countries' banking sectors and to the effects of those weaknesses on macroeconomic stability' (see here).

Nevertheless, the IMF's steadfast view on the conduct of fiscal policy wavered as the recession deepened and the primary policy instrument, monetary policy, became largely ineffective. By 2009 the IMF began to advocate fiscal stimulus, conceding that 'past experience suggests that fiscal policy is particularly effective in shortening the duration of recessions caused by financial crisis' (IMF, 2009:xix, quoted in Sharpe and Watts, 2012).

In 2010, the IMF admitted 'we were wrong' with respect to the importance of (counter-cyclical) fiscal policy (Blanchard et al. 2010:3-9). Furthermore, the Fund conceded that while '[t]he crisis was not triggered primarily by macroeconomic policy...it has exposed flaws in the pre-crisis policy framework...' (Blanchard et al. 2010:16, quoted in Sharpe and Watts, 2012).

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Since the advent of the GFC the IMF has slightly moderated its stance on (discretionary) fiscal policy, particularly regarding its effectiveness during economic downturns (i.e. for stabilising purposes). However, the use of fiscal policy is still heavily qualified by concerns of fiscal sustainability. For this reason, the IMF continues to advocate fiscal austerity or consolidation measures, albeit, in light of the poor economic outcomes with some caution regarding the timing of these programs (Sharpe and Watts, 2012).

The use of certain terminology has formed a particularly important feature of IMF policy documents. Language such as sound public finance, fiscal sustainability, fiscal space and fiscal credibility typically accompany IMF discussions of fiscal policy (see Sharpe and Watts, 2012). However these terms are often left undefined which, firstly, reflects the lack of consensus among economists regarding *operational* definitions, secondly, the language is used to portray a depth of understanding and sense of authority (see Watts, 2010), and finally, the IMF strategically use vagueness and rhetorical tautology to render its policy statements ostensibly unfalsifiable.

Notwithstanding the policy rhetoric, the principal flaw within IMF policy advice is a failure to adequately distinguish between a sovereign and non-sovereign economy which has important implications for the conduct of fiscal policy. Modern Monetary Theory makes the distinction (see Mitchell and Muysken, 2008; Wray, 1998, 2012).

## Sovereign vs. non-sovereign

A sovereign economy operates with its own (fiat) currency and a flexible exchange rate (e.g. the U.S., U.K., Japan and Australia). A non-sovereign economy does not possess these characteristics (e.g. Eurozone economies, such as Greece, Spain, Ireland and Portugal). In essence, one must distinguish between a currency 'user' (non-sovereign government) and a currency 'issuer' (sovereign government) (Kelton, 2011).

Unlike sovereign governments, non-sovereign (e.g. Eurozone) governments do face financing constraints. They are users of a currency and *must* borrow that currency (e.g. euros) if tax revenues are not enough to cover government expenditures. Thus, these economies become exposed to pressures from bond market investors and credit-rating agencies since the use of, what is effectively, a foreign currency implies these economies can become insolvent with respect to obligations denominated in that currency. The threat of insolvency has recently contributed to high long-term government bond rates among some Eurozone economies (e.g. Greece). By contrast, sovereign economies maintain very low long-term interest rates, including Japan which, according to OECD data, has a (gross) government debt to GDP ratio now in excess of 200 percent (currently the highest ratio in the world).

Thus, equating these different economic arrangements in terms of IMF policy advice is a fundamental flaw. A sovereign economy cannot become insolvent with respect to obligations denominated in its own currency, and can always purchase goods and services available in its own currency. Hence, mainstream notions of fiscal sustainability are irrelevant to the conduct of fiscal policy in sovereign economies. Rather, policies to reduce government deficits and debt (i.e. fiscal austerity) within sovereign economies such as the U.K., U.S. and Australia, are entirely voluntary, unnecessary and ideologically motivated. The reasons are largely political and may reflect a long standing fear of 'big' government or any government intervention which 'threatens' private sector activity (see here).

Furthermore, in their policy statements, the IMF tend to 'trivialise the conduct of fiscal policy by implying that, like prudent households, *all* national governments are budget constrained' (Watts, 2010, quoted in Sharpe and Watts, 2012:122). Thus, a government in pursuit of 'responsible' or 'sound' fiscal policy by reducing deficits and debt appear to be prudent managers of 'taxpayer' funds. While these claims have no economic foundation within a sovereign economy, such statements play on the entrenched (neo-liberal) beliefs within society and therefore may prove useful as an election strategy (e.g. Australia's 'surplus fetish' politics, see here).

## The Eurozone

The establishment of the Eurozone (or European Monetary Union) included an attempt by policymakers to formally constrain fiscal policy in terms of the Stability and Growth Pact (SGP) requirements (i.e. 60% gross debt to GDP and 3% general government deficit to GDP). When joining the Eurozone an economy, firstly, surrenders monetary

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sovereignty (e.g. setting the official interest rate) to the European Central Bank (ECB). Secondly, the (nominal) exchange rate can no longer freely fluctuate to buffer country specific economic shocks. Finally, fiscal policy is subjected to 'formal' constraints and therefore becomes inherently pro-cyclical.

In essence, a government's budget is an outcome which reflects the spending decisions of the non-government (private and external) sector. During an economic recession, a budget deficit may occur as unemployment increases, social security transfers rise and tax revenues fall. This is a normal process which indicates that the automatic stabilisers are working to offset the economic slowdown. In fact, (discretionary) fiscal stimulus measures have hardly contributed to the recent rise in budget deficits among many advanced economies (see Sharpe and Watts). Nevertheless, the budget outcome may conflict with voluntarily adopted SGP requirements. Consequently, Eurozone economies have pursued fiscal austerity programs which target a reduction in government expenditure and/or tax increases. Furthermore, fiscal austerity has formed an important feature of IMF, EC and ECB (i.e. Troika) supported loans.

While the government pursues fiscal austerity in an attempt to meet SGP requirements, the return to economic growth requires a private (or external) sector led recovery. However during a recession, business confidence may be low, and the private sector may be unwilling to increase its consumption or investment expenditures, perhaps choosing instead to delay investment projects, pay down high private debt levels (a major feature of the pre-GFC period), or increase savings. For example, OECD data reveals that U.S. household net saving rates (as a percent of disposable household income) more than doubled between 2007 and 2008 (i.e. the start of the GFC) from 2.4 to 5.4 percent.

In this context, fiscal austerity measures will increase government debt and deficits. Harsher austerity programs may then be pursued by policymakers, or such measures may be required as a condition of a Troika bailout (and the vicious cycle continues). In this vein, the IMF ostensibly promotes an extreme form of neo-liberal macroeconomic policy, the continuation of which will only exacerbate the Eurozone malaise (see Sharpe and Watts, 2012).

## Going forward

Sovereign governments should now be engaging in well targeted expenditure programs (fiscal stimulus) to boost employment and economic growth. For Eurozone economies, two broad options are apparent: First, abandon the Euro and re-establish a sovereign currency system. Second, create a fiscal union including the establishment of a Eurozone Treasury which could spend like a sovereign government. The latter however may pose a significant challenge to the democratic process (see Sharpe and Watts, 2012).

Despite the outcome, current unemployment rates, for example exceeding 20 percent in Spain and Greece, are unacceptable, irresponsible and avoidable as long as the government restores its currency sovereignty and uses fiscal policy effectively to stimulate employment and growth. In this vein, MMT advocates promote a Job Guarantee otherwise known as Employer of Last Resort as a full employment strategy (see here and here).

## Conclusion

The failure to adequately distinguish between sovereign and non-sovereign economies has corrupted IMF policy advice. Reforming the IMF, however, is problematic since its policies largely reflect the prevailing neo-liberal economic agenda.

Notwithstanding this, national policymakers, unlike IMF officials, have an *elected* obligation to advance the public purpose and maintain full employment. The pursuit of accounting fundamentals (i.e. *targeting* specific or reduced government deficits and debt ratios) must not override nor inhibit a concerted policy effort to reduce unemployment and alleviate poverty. For this reason, national governments must be accountable for their failure to provide adequate employment opportunities and promote growth in the aftermath of the GFC.

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## Notes

This article draws from Sharpe and Watts (2012). Please refer to this paper for a detailed discussion and critique of IMF (and OECD) policy advice during the GFC.

More information on Modern Monetary Theory (MMT) can be found at Billy Blog and New Economic Perspectives.

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